United States General Accounting Office

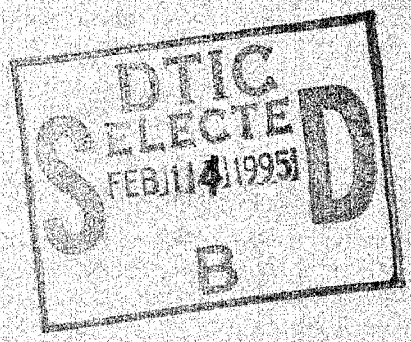
GAO

Report to Congressional Committees

April 1992

# SECURITIES FIRMS

## Assessing the Need to Regulate Additional Financial Activities






GAO/GGD-92-70

GAO

**United States**
**General Accounting Office**
**Washington, D.C. 20548**

**General Government Division**



B-245591.2

April 21, 1992

The Honorable Donald W. Riegle
Chairman, Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable Christopher J. Dodd
Chairman, Subcommittee on Securities
Committee on Banking, Housing and
Urban Affairs
United States Senate

The Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
House of Representatives

The Honorable Edward J. Markey
Chairman, Subcommittee on Telecommunications
and Finance
Committee on Energy and Commerce
House of Representatives



This report examines the issues associated with the regulatory structure for overseeing the domestic and foreign affiliates of U.S. broker-dealers. We are sending you this report because it is directed at the Securities and Exchange Commission.

We are concerned about the unregulated financial activities of the affiliated and holding companies of U.S. securities firms, especially given the collapse of Drexel Burnham Lambert. The report recommends that SEC use its new authority under the Market Reform Act of 1990 to obtain information to evaluate the risks of these activities and to determine the need for any further regulation of them.

Major contributors to the report are listed in appendix II. If you have any questions, please call me on (202) 275-8678.

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

# Executive Summary

## Purpose

The 1980s were an unprecedented period of profitability and growth in the securities industry. For example, total capital held by U.S. broker-dealers increased from about $10 billion in 1980 to about $49 billion in 1990. Firms doing securities business diversified domestically, increased activities in foreign markets, and in some cases were acquired by large nonfinancial conglomerates. Many of the financial activities of these firms are now done outside the traditional scope of federal and state regulation. The number of these activities is increasing, but little is known about their total size and scope or about the risks they pose to regulated entities and their customers, the financial system, or ultimately the federal government.

GAO is concerned about the proliferation of unregulated financial activities and the potential effects on U.S. investors and the financial system. Thus, GAO examined the organization and regulatory structure for large U.S. firms that do securities business to identify whether regulatory gaps exist that might affect U.S. investors and the financial system. GAO also compared the regulation of these firms to the different regulatory approaches for bank holding companies and foreign firms doing securities business to determine the applicability of these approaches to U.S. firms doing securities business.

## Background

U.S. firms that buy or sell stocks and bonds for the public or for themselves are called "broker-dealers." Corporate organizational structures that include these firms are diverse and complex, with financial activities done in many different entities. Some broker-dealers, such as Morgan Stanley & Co. Incorporated, are the largest parts of holding companies that may also include other subsidiaries, such as a government securities dealer. Other broker-dealers, such as Prudential Securities Inc., may be a smaller part of a much larger financial or commercial parent firm, in this case, the Prudential Insurance Company of America. The parent firm may include several holding companies and hundreds of subsidiaries and affiliates that are involved in a wide range of commercial and financial activities.

The securities activities of firms are regulated by both federal and state regulators in the United States and by foreign regulators in other countries. For example, the Securities and Exchange Commission (SEC) regulates buying and selling securities products, underwriting corporate debt, and management of customers' investment accounts. Some of these activities may also be subject to state securities regulation. Other activities may be federally regulated by the Commodity Futures Trading Commission, the U.S. Treasury, or the Federal Reserve Board. Some U.S. securities firms

also have subsidiaries in other countries that are subject to foreign regulation. Despite numerous regulators, however, some financial activities of these firms, such as foreign currency trading, are not subject to any government regulation.

## Results in Brief

During the 1980s, the U.S. securities business became concentrated in large broker-dealer firms, which themselves became part of more complex organizations. These firms developed and offered a wider array of financial products and services than had been previously available to investors. Not all of these new activities are regulated by the SEC or by other federal regulators, and they may pose additional risks to the regulated parts of the firm.

The potential adverse effects of these unregulated activities on the regulated entities were illustrated by the bankruptcy of Drexel Burnham Lambert Group Inc. (Drexel), a financial conglomerate with a large broker-dealer subsidiary. Because of funding problems associated with holding company activities, management removed capital from its broker-dealer subsidiary. Eventually, the whole firm went into bankruptcy. However, regulators successfully helped transfer customer accounts to other firms, and American taxpayers have incurred no costs as a result of the bankruptcy.

U.S. securities laws have focused U.S. regulation on certain subsidiaries of complex securities firms such as SEC's regulation of the broker-dealer. Thus, not only are some activities unregulated, but also no single regulator is responsible for oversight of the activities of the entire firm. This approach was modified, however, by the Market Reform Act of 1990, which authorized SEC to require that broker-dealers routinely provide financial information on their unregulated activities. SEC plans to use this information to assess for each firm the risks unregulated activities pose to broker-dealers and their customers, and has proposed rules that require firms to maintain and preserve records for this risk assessment.

SEC's authority under the act may be a step toward more consolidated regulation of U.S. securities firms, but it provides SEC only with risk assessment information, not additional power to control the risks it finds. This approach differs from the regulatory procedures for bank holding companies, which are subject to consolidated regulation by the Federal Reserve. Also, foreign firms doing securities business are often subject to regulatory structures in their countries that provide either broader

coverage of their financial activities or consolidated regulation. However, important differences exist between the purposes of regulation for U.S. securities firms and banks and foreign firms doing securities business, such as the federal government's role in protecting bank deposits, that help explain the different regulatory approaches.

The opinions of firm officials and regulators were divided on whether SEC's authority over U.S. securities firms should be expanded to cover all their financial activities. Resolving this issue will require more information on the investor and financial system risks posed by unregulated financial activities. SEC's analysis of the data it will collect under the Market Reform Act of 1990 will help it identify the risks of these activities to each firm and especially to the broker-dealer. Broadening the analysis to include evaluating the overall risks to investors, the financial system, and, ultimately, the U.S. government also may help SEC assess any need for expanding its regulatory authority.

# GAO's Analysis

## Complex Organization and Diverse Activities May Increase Risks

In 1980 the top 10 U.S. broker-dealers held $3.4 billion in capital, or about 34 percent of all U.S. broker-dealer capital. By 1990 the top 10 firms held nearly $23 billion, or about 47 percent of all U.S. broker-dealer capital. The concentration of capital in a few firms increases risks to the financial system should one of the firms fail. (See pp. 21-22.)

During this same period, some of these firms were acquired by large commercial or financial conglomerates. These firms do an array of financial activities, including making loans to finance merger and acquisition activities, trading foreign currencies, or selling insurance. Many of these activities are done by subsidiaries other than the broker-dealer and fall outside the traditional scope of securities regulation. (See pp. 30, 35-37, and 56-58.)

Holding companies and their subsidiaries, including the broker-dealer, are generally distinct individual legal entities that maintain separate funds and records. However, funds do flow among corporate entities as needed to meet corporate goals. Such financial interdependence among affiliated corporate entities increases the possibility that losses from activities in one subsidiary could adversely affect other subsidiaries and the entire firm. (See pp. 31-34 and 40-44.)

This possibility was realized in Drexel's bankruptcy. The parent firm experienced difficulty borrowing funds to meet its short-term liabilities because it could not get unsecured credit, and it was unable to use its high yield bond portfolio as collateral. The parent firm withdrew about $220 million from its broker-dealer before SEC prohibited further withdrawals. This action preserved the solvency of the broker-dealer, but the parent firm's resulting bankruptcy eventually caused the broker-dealer and other subsidiaries also to declare bankruptcy. Individual investors' accounts were transferred to another firm, and no investors lost money as a result of the bankruptcy. (See pp. 44-46.)

## Scope of U.S. Laws Limits Regulation of Securities Firms

Federal and state regulation applies only to parts of the large, complex firms that do securities business in the United States, such as the broker-dealer or government securities dealer. The federal regulatory approach has been to isolate the financial stability of regulated subsidiaries from the rest of the firm. For example, SEC requires broker-dealers to maintain sufficient net liquid assets, called "regulatory net capital," to promptly satisfy their liabilities to customers and other creditors. Regulatory net capital enhances a firm's financial stability by allowing it to absorb losses, and helps protect a firm's customers. Following the problems experienced at Drexel, SEC amended its net capital requirements to require broker-dealers to notify SEC of large capital withdrawals made to benefit affiliated entities and to give SEC authority to temporarily halt capital withdrawals in certain situations. (See pp. 47-53.)

Until recently, SEC did not have authority to require firms to provide financial information about the whole firm. Although Drexel supplied financial information on the whole company when SEC asked for it, until the Market Reform Act of 1990 SEC was not authorized to routinely gather information from broker-dealer holding companies and unregulated affiliates. Despite this change, SEC's authority to take regulatory action, however, is still limited to specific subsidiaries. (See pp. 23-24, 57, and 60-61.)

## U.S. Banking and Foreign Securities Regulators Take Comprehensive Approaches

The Federal Reserve and foreign regulators have taken fundamentally different approaches to regulating large, multiservice financial firms than SEC has taken to regulating large securities firms. For example, the Federal Reserve exercises control over the activities of bank and nonbank subsidiaries, applies its capital standards to the entire holding company,

and monitors financial relationships between banks and their affiliates. (See pp. 63-65.)

In some countries with financial markets that are comparable to U.S. markets, the structure of regulation of firms doing securities business covers more financial activities than U.S. regulation. In some more centralized foreign regulatory structures, coordination of bank and securities firm regulation is achieved by a central agency, as in Japan. In some decentralized regulatory structures, coordination has been achieved by cooperation among functional regulators with one regulator setting the capital standards, as in the United Kingdom. But the form of regulation does not necessarily ensure effective regulation. Nearly all the activities of securities firms that operate in both of these foreign regulatory structures are done in regulated entities and are subject to capital requirements. Financial activities of U.S. securities firms that are unregulated in the United States may be regulated by the foreign regulators if subsidiaries of these firms do this business in foreign markets. (See pp. 67-71.)

The reasons vary as to why banks and foreign securities regulation take different approaches than U.S. securities regulation. U.S. consolidated regulation of banks and their holding companies arises out of the direct federal liability for insured deposits and the need to maintain a stable banking system. Foreign regulators that use a consolidated approach do so not only to protect investors and the financial system, but also to prevent securities firms from failing. Other foreign regulatory approaches do not necessarily attempt to keep firms from failing, but try to regulate all financial activities done in their marketplace to protect investors and their financial system. (See pp. 72-74.)

## Lack of Consensus on Need to Regulate Securities Firm Holding Companies

No consensus exists among market regulators, participants, or observers about the need to change this structure to regulate currently unregulated financial activities of firms. Some regard the current regulatory structure as adequate. Others, especially foreign regulators, are concerned that the U.S. regulatory structure ignores risks to the global financial system introduced by unregulated financial activities. (See pp. 75 and 81-82.)

To date, the U.S. regulatory structure has provided adequate protection to investors and the financial system in times of stress such as the market crash of 1987 and the failure of Drexel. (See pp. 75-76.)

SEC has begun to address concerns about the effects of holding company and affiliate activity on the broker-dealer firm, for example, by requiring broker-dealers to notify SEC about large capital withdrawals. Further, SEC plans to use the information it will collect under the Market Reform Act to assess, for each firm, the potential risks that such activities could have on a broker-dealer. It will also use the information to provide early warning of adverse financial circumstances, such as those that led to Drexel's bankruptcy. In addition, SEC officials said they may use the information to assess the overall risks these activities present to the financial system. (See pp. 59-61.)

Such an assessment is valuable because the size and scope of those activities is increasing. Furthermore, little is known about the risks they pose, not only to regulated entities and their customers, but also to the financial system and ultimately the federal government. This assessment would also be useful for evaluating whether, and if so how, such activities should be regulated in the future. (See p. 84.)

## Recommendation

GAO recommends that the Chairman, SEC, use the Market Reform Act provisions to gather and study data both to accommodate its current regulatory approach and to determine whether the overall risks posed by the unregulated financial activities of broker-dealer holding companies and affiliates warrant additional regulation. If SEC determines that additional regulation is warranted, it should identify any needed legislative or regulatory changes and report its results to Congress as soon as possible.

## Agency Comments

SEC commented on a draft of the report in a letter reproduced in appendix I and discussed, along with GAO's comments, in chapter 5. In its comments on GAO's report, SEC said that it is establishing risk assessment rules to obtain information regarding certain activities of broker-dealer affiliates, subsidiaries, and holding companies as authorized by the Market Reform Act of 1990. SEC believes that obtaining this information is the preferred approach to dealing with risks in a holding company structure. SEC opposes consolidated supervision and regulation at the holding company level because this would impose unnecessary costs on the consolidated entities, could discourage investment in broker-dealers, and could involve securities regulators in regulating diverse activities such as manufacturing and retailing. SEC also states that after gaining experience with the information obtained under its risk assessment rules, it will determine

whether any revisions or modifications to the rules are needed and whether any additional legislation is warranted in this area.

SEC's plan to gain experience with the data and then to determine whether additional rule or legislative changes are needed is consistent with the intent of GAO's recommendation. However, GAO is concerned that SEC's stated opposition to consolidated regulation indicates that SEC may have already determined, without first collecting and analyzing the data, that just obtaining information is the preferred approach to dealing with the potential risks posed by the unregulated financial activities of broker-dealer affiliates and holding companies.

# Contents

## Abbreviations

| | |
|---|---|
| CFTC | Commodity Futures Trading Commission |
| FCM | futures commission merchant |
| FRBNY | Federal Reserve Bank of New York |
| FSA | Financial Services Act |
| MOF | Ministry of Finance |
| NASD | National Association of Securities Dealers |
| NYSE | New York Stock Exchange |
| OECD | Organization for Economic Cooperation and Development |
| SEC | Securities and Exchange Commission |
| SIB | Securities and Investments Board |
| SIPC | Securities Investor Protection Corporation |
| SRO | self-regulatory organization |

# Introduction

Worldwide financial markets, while never stagnant, have experienced dramatic evolution over the last 10 years. Annual trading volume of securities, futures, and other financial products has increased substantially since 1980, largely due to institutional investor activity. Innovations in the futures and options markets helped investors profit from, and manage risk in, an increasingly global marketplace. Technological advances and growing domestic and foreign competition have contributed to interconnected domestic and worldwide markets. Large U.S. securities firms, in response to these developments, have diversified their activities and expanded their operations into foreign markets. Although these firms experienced increased revenues during most of the 1980s, they have been adjusting in recent years to a less profitable marketplace complicated by competition from banks and foreign firms. Regulation of securities firms over this period has been shared among many federal and state regulatory agencies.

## Global Financial Markets Have Changed Dramatically Since 1980

U.S. securities and futures markets experienced substantial growth and change during the 1980s. For example, average daily trading volume on the New York Stock Exchange (NYSE) nearly quadrupled during the past decade from about 45 million shares in 1980 to 165 million shares in 1989. The value of NYSE's annual share trading volume also nearly quadrupled during this time, from about $375 billion in 1980 to over $1.5 trillion in 1989.[1] NYSE's average daily trading volume dropped during 1990 to about 157 million shares, and the annual value of such trading declined to about $1.3 trillion. Trading volume in the United States for derivative products, such as stock options and interest rate or foreign currency futures, also expanded during the 1980s. The number of options contracts traded on U.S. exchanges grew from about 97 million in 1980 to 227 million in 1989, while total futures contracts traded during this time grew from about 92 million to about 267 million.

Foreign markets experienced similar growth during the past decade. For example, the Tokyo Stock Exchange became the world's largest equity market, based on the market value of annual share trading volume. Many emerging equity markets in less developed countries also grew rapidly during the 1980s. According to price indexes developed by the

[1]Similarly, average daily volume for the National Association of Securities Dealers (NASD) over-the-counter market, the second largest U.S. marketplace, reached over 133 million shares in 1989, up from about 27 million in 1980. The value of NASD's annual share trading volume increased from about $69 billion in 1980 to over $431 billion in 1990.

International Finance Corporation, a subsidiary of the World Bank, the eight markets experiencing the largest priced index increases in the world during 1990 were in developing countries.[2] Table 1.1 shows the market value of trading volume at the top 10 stock exchanges during 1990, excluding bond trading.

**Table 1.1: Market Value of Equity Trading Volume for 10 Largest Stock Exchanges During 1990**

Dollars in millions

| Stock exchange | Market value of equity trading volume[a] |
|---|---|
| Tokyo | $1,403,887 |
| New York | 1,325,332 |
| London | 587,808 |
| Federation of German Stock Exchanges | 554,208 |
| Zurich | 400,253 |
| Paris | 127,019 |
| South Korea | 74,616 |
| Midwest | 71,304 |
| Vienna | 59,313 |
| Toronto | 55,166 |
| **Total** | **$4,658,906** |

Note: In 1990 the value of over-the-counter stocks traded in the United States over the National Association of Securities Dealers Automated Quotations System was $452.4 billion.

[a]Figures are translated to U.S. dollars at year-end 1990 exchange rates.

Source: Federation Internationale des Bourses de Valeurs 1990 Statistics.

Institutional investors, such as pension funds, insurance companies, and investment companies, have been a driving force behind the growth in securities and futures markets. According to the NYSE's 1990 Institutional Investor Fact Book, total institutional assets in the United States increased from almost $1.8 trillion in 1980 to over $5 trillion in 1988. This growth has been encouraged by the increasing likelihood that individual investors

[2]The International Finance Corporation has classified 20 equity markets based in less developed countries as emerging markets, including Argentina, Brazil, Chile, Colombia, Greece, India, Indonesia, Jordan, South Korea, Malaysia, Mexico, Nigeria, Pakistan, Philippines, Portugal, Taiwan, Thailand, Turkey, Venezuela, and Zimbabwe. See Emerging Stock Markets Factbook, International Finance Corporation (Washington, D.C.: 1991).

will participate in the marketplace through institutions, such as mutual and pension funds. Institutions, which typically own and trade large amounts of stock, have accounted for about one-half of NYSE's total share trading volume since 1984.[3]

Institutionalization of the marketplace has also influenced the development and use of options, futures, and indexes, which help institutions manage various risk factors present in their large, diversified portfolios. During the 1980s, many new products were introduced that provided links between securities and futures markets, as well as between domestic and foreign markets. These products include futures and options on foreign currency, stock indexes, and domestic and foreign interest rates. The Commodity Futures Trading Commission (CFTC) annual reports show that while futures on financial instruments and currencies represented about 17 percent of all futures contracts traded on U.S. futures exchanges in 1980, this ratio increased to about 60 percent in 1990.

Technological advances in information processing and telecommunication provide market participants with accurate, timely trading information and have made it feasible for investors to participate in worldwide capital markets. Quotation and trading data about U.S. and foreign stocks are available on a 24-hour basis through domestic and foreign information vendors. Using this information, brokerage firms and sophisticated investors can trade in foreign markets when U.S. exchanges are closed. Because of increased "after-hours" competition from foreign markets, several U.S. securities and futures exchanges are developing automated trading facilities that will operate while domestic exchanges are closed.[4] In addition, nonexchange trading systems have been developed that allow

[3]Institutional investors have counted for slightly over 40 percent of the trading of NASD Automated Quotation System National Market System stocks since 1984.

[4]In June 1991 the New York Stock Exchange began two sessions that allow investors to trade stock after the exchange is closed. The National Association of Securities Dealers and some regional stock exchanges have received the Securities and Exchange Commission's approval to expand their regular trading hours to match either NYSE's after-hours session or the trading day in London. Currency options and futures can be traded on the Philadelphia Stock Exchange from 6:00 p.m. to 2:30 p.m. (Eastern Standard Time) the next day. Also, a 24-hour futures trading system called GLOBEX is being developed by the Chicago Mercantile Exchange, Chicago Board of Trade, and Reuters Holdings PLC, a financial news vendor based in the United Kingdom.

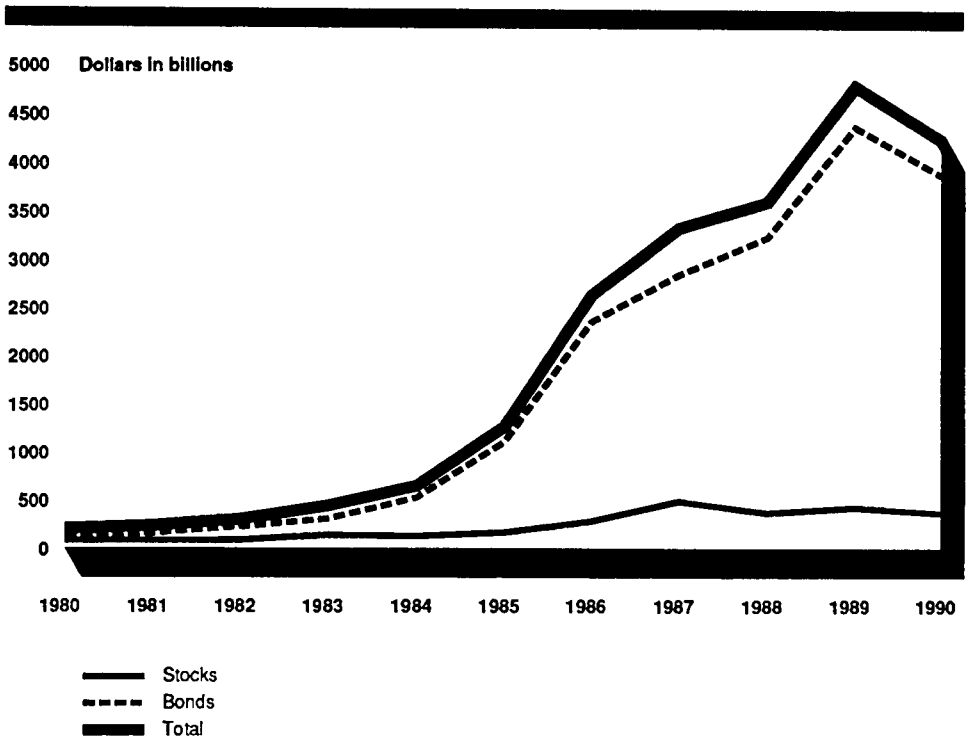
institutions and broker-dealers to trade large blocks of stock among themselves rather than through a recognized exchange.[5]

Domestic and foreign markets are linked in other ways as well. For example, the stocks of several hundred companies from various countries are listed and traded on exchanges outside of their domestic market. Cross-border transactions—the purchase and sale of securities by U.S. investors in foreign markets (or foreign investors in U.S. markets)—have steadily increased over the last decade. These trends are shown in figures 1.1 and 1.2. As interest in foreign financial markets and products has increased, many U.S. broker-dealers have established or expanded operations abroad. Some of these firms are wholly or partially owned by foreign companies, while a number of foreign firms operate in the United States.[6]

[5]For example, the Instinet Corporation operates a communication and trading system through which professional investors can trade 9,000 U.S. securities and 300 securities listed on the International Stock Exchange in London. The system displays the buy and sell interest of Instinet subscribers and allows them to execute trades when a match can be made between subscribers.

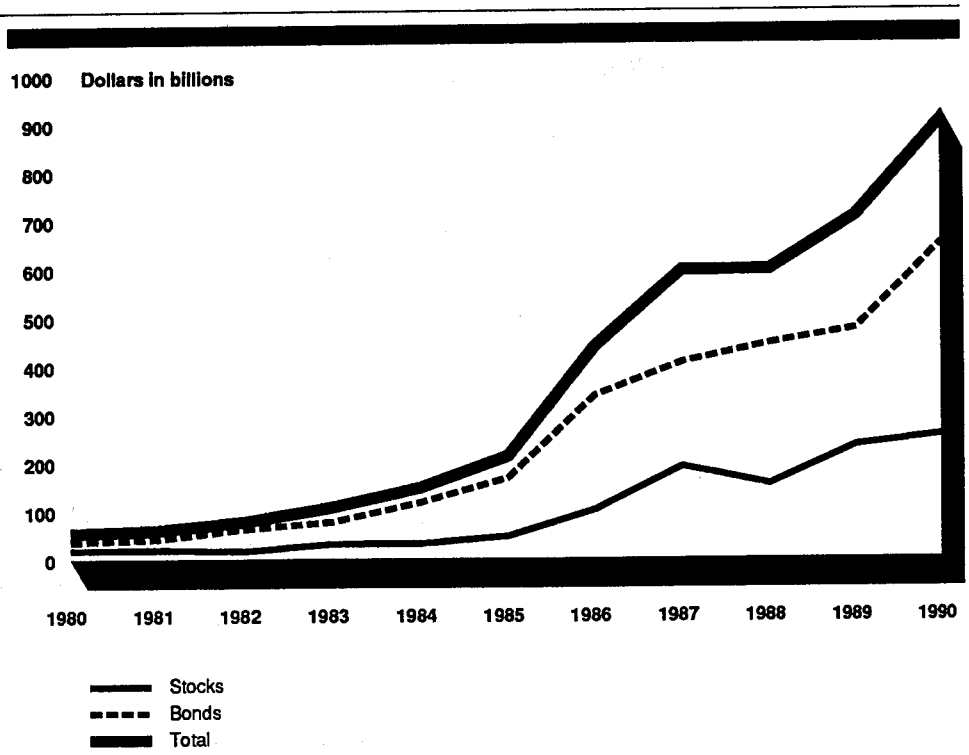
[6]The First Boston Corporation is a subsidiary of CS First Boston, Inc., which is 45 percent owned by the parent of Credit Suisse, a Swiss bank; Nippon Life Insurance Company, a Japanese firm, owns 13 percent of Shearson Lehman Hutton Holdings Inc.; another Japanese insurer, Yasuda Mutual Life Insurance Company, owns about 21 percent of the Paine Webber Group Inc.; and Sumitomo Bank has a large nonvoting stake in Goldman, Sachs & Co.

**Figure 1.1: Foreign Purchases and Sales of U.S. Stocks and Bonds, 1980-1990**




Source: U.S. Treasury Bulletin.

**Figure 1.2: U.S. Purchases and Sales of Foreign Stocks and Bonds, 1980-1990**




Source: U.S. Treasury Bulletin.

## Securities Firms Have Responded to Changes in the Marketplace

In order to keep pace with a rapidly evolving marketplace, many securities firms have entered new lines of business, diversified the products and services they offer to investors, and expanded their operations into foreign markets. In the process, they have become complex organizations made up of numerous legal entities. As a result, industry revenues and capital have increased substantially since 1980, bolstered especially by the merger and acquisition activity of the mid-1980s. However, the market became sluggish after the October 1987 crash, causing decreases in industry profits and the bankruptcy of a major securities firm. These events have led to some changes in the Securities and Exchange Commission's (SEC) regulation of securities firms.

## Changing Structure and Activities of Securities Firms

Historically, the U.S. securities industry was made up of broker-dealers whose main purpose was to underwrite,[7] buy, and sell securities, such as stocks and bonds, on behalf of companies and public investors. The role and activities of broker-dealers have evolved over time with changes in securities markets. Today, some broker-dealers operate within large firms that are organized under a holding company and engage in a wide range of financial activities. Other broker-dealers are owned by corporations that are primarily commercial in nature. Chapter 2 discusses in more detail the organizational structure and activities of large U.S. broker-dealers and the firms with which they are associated.

Because of these changes, the term "broker-dealer" does not apply to the entire organization active in the securities industry. While industry participants and regulators usually refer to such organizations as "securities firms," it is important to note that this term is not easily defined. The organizational structure of a firm that is involved in the securities industry can be very complex. Within such a firm, many legal entities can engage in financial activities that relate directly or indirectly to the organization's securities business. Thus, it is difficult to know what portion of an organization is defined by the term "securities firm."

For purposes of clarity in this report, we consider a securities firm to be those parts of an organization that trade or invest in securities and related financial products, including a broker-dealer, its holding company if one exists, and other financial subsidiaries organized under the holding company.[8] In some cases, this definition encompasses most or all of an organization's legal entities. In other cases, the definition may only apply to part of the organization, the remainder of which would generally be involved in commercial activities. Although the commercial activities of these firms may also create financial risk to the firm, we focused only on those risks posed by financial activities. Further, differentiating commercial and financial activities may be difficult in some cases and is beyond the scope of our work.

[7]Broker-dealers underwrite securities when they bring new securities into the market by purchasing whole or partial issues from businesses or government agencies and reselling them to other investors.

[8]As discussed in chapter 3, the subsidiaries of these firms may be subject to regulation by several federal or state regulatory entities. The business of the federally regulated subsidiaries of the firms we reviewed for this report was primarily securities related and thus regulated by SEC. We did not examine firms with other predominant financial subsidiaries that would be regulated by other federal regulators, such as futures commission merchants (FCM) regulated by CFTC.

In addition to changing their organizational structure during the 1980s, broker-dealers and the securities firms with which they are associated also expanded their range of activities. Broker-dealers were able to offer many new products both to their individual and their institutional customers. Outside their broker-dealer, many large securities firms began to negotiate and provide financing for corporate mergers, acquisitions, and leveraged buyouts. Most firms we studied also engaged in financial activities not related to the securities industry, such as insurance or real estate.

## U.S. Securities Firms Had Strong Financial Positions Throughout Most of the 1980s

Many U.S securities firms increased their capital base during the 1980s to enhance their ability to compete in capital-intensive activities, such as financing mergers and acquisitions. They also enjoyed sharp revenue growth and strong profitability during most of the past decade, as their expanded range of activities provided new sources of income. However, for several years after the October 1987, market crash, securities industry revenues and profits decreased, not recovering again until late in 1990 and in 1991.

The only standardized numbers we found to indicate securities firm capital are those SEC collects for the broker-dealer subsidiaries it regulates. According to SEC data, broker-dealer capital increased from about $10 billion in 1980 to about $49 billion in 1990. Moreover, the percent of industry capital held by the 10 largest broker-dealers increased from about 34 percent in 1980 to about 47 percent in 1990. Table 1.2 shows the trends in broker-dealer capital and capital concentration during the past decade.

**Table 1.2: Total Capital of U.S. Broker-Dealers and Percentage Held by 10 Largest Firms, 1980-1990**

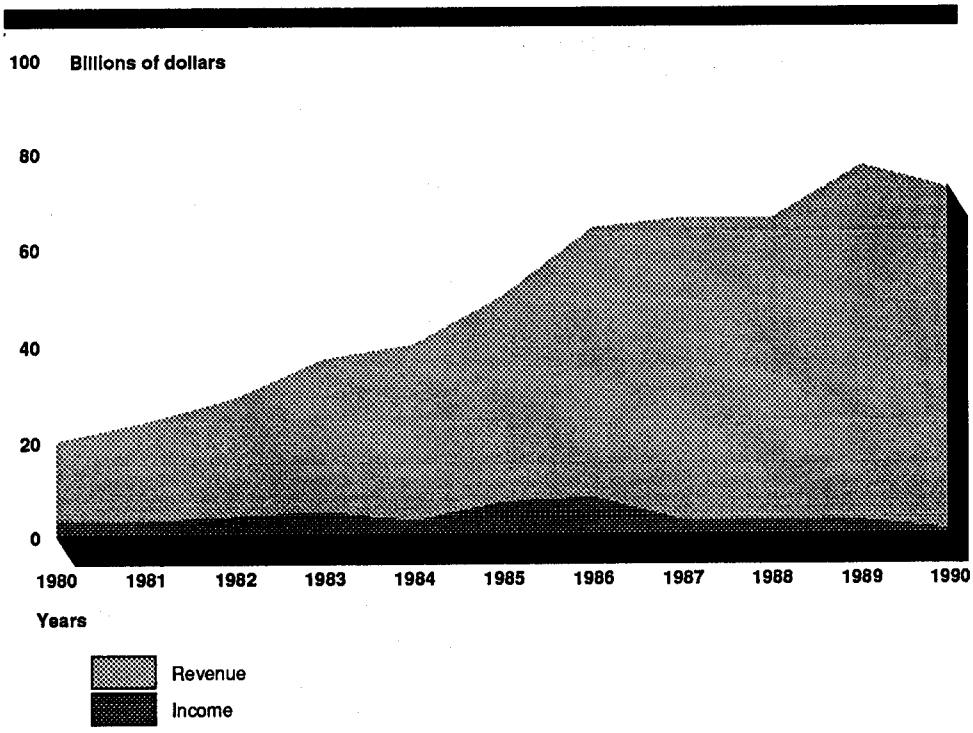
Dollars in billions

| Year | Total capital of U.S. broker-dealers | Percent of total capital held by 10 largest firms |
|---|---|---|
| 1980 | $10.1 | 34 |
| 1981 | 11.8 | 36 |
| 1982 | 15.4 | 38 |
| 1983 | 19.9 | 38 |
| 1984 | 23.6 | 42 |
| 1985 | 30.9 | 45 |
| 1986 | 42.0 | 44 |
| 1987 | 46.9 | 45 |
| 1988 | 50.6 | 46 |
| 1989 | 51.7 | 47 |
| 1990 | 49.3 | 47 |

Source: SEC data.

Broker-dealer annual revenues also generally increased during the decade from about $20 billion in 1980 to about $72 billion in 1990. Broker-dealer pretax income fluctuated during this time, reaching a high in 1986 of about $8 billion and a low in 1990 of about $0.7 billion. Although the market has been sluggish since October 1987, revenues have continued to increase, but income has declined. The profitability of broker-dealers, measured by income as a percent of revenue, has generally decreased from about 15 percent in 1980 to about 1 percent in 1990. Figure 1.3 compares trends in broker-dealer revenues and income from 1980 to 1990.

**Figure 1.3: Broker-Dealer Revenue and Income Trends, 1980-1990**




Source: FOCUS Report, Office of Economic Analysis, SEC.

Some industry analysts anticipate that, even as market conditions improve, the competition securities firms will face during the 1990s will probably keep their profits modest. Competition may come from foreign securities firms or from U.S. banks that have been authorized to engage in certain securities activities. These analysts suggest that, in order to remain competitive, firms must continue to cut costs, find new sources of revenue, and focus on their most profitable business lines.

## Drexel Bankruptcy Leads to Changes in SEC's Regulatory Authority

Drexel Burnham Lambert Group Inc. (Drexel) was the holding company of one of Wall Street's largest broker-dealers, Drexel Burnham Lambert, Inc. Like other securities firms, it grew rapidly during the 1980s and became a prominent player in arranging and financing mergers, acquisitions, and leveraged buyouts. However, Drexel encountered severe financial difficulties at the beginning of 1990 that led it to withdraw about $220 million of capital from its broker-dealer. The holding company ultimately filed for bankruptcy in February 1990.

Despite the holding company's failure, the broker-dealer and other subsidiaries were still solvent and able to operate. However, market participants and creditors had lost confidence in the firm and were unwilling to enter into new transactions with any of its subsidiaries. Regulators helped transfer the broker-dealer's customer accounts to other firms, and the broker-dealer's operations were wound down.

Numerous causes were cited for Drexel's sudden failure, including funding problems and financial activities within the holding company. The holding company's financial activities that caused Drexel's collapse were not subject to SEC regulation, which is limited to certain subsidiaries, including broker-dealers. At the time, SEC had no authority to obtain information on the financial condition of the rest of the firm, although Drexel provided it upon SEC's request.

In March 1990 testimony before the Senate Committee on Banking, Housing and Urban Affairs, SEC Chairman Richard Breeden stated that Drexel's bankruptcy illustrated the need for prompt action on the Market Reform Act, which was being considered by Congress at the time. This legislation, which was enacted in October 1990, expanded SEC's authority to obtain information about the financial condition and activities of broker-dealer holding companies and affiliates, in order to assess any risks they may present for broker-dealers. SEC has issued proposed rules that require firms to maintain and preserve records for this risk assessment.

## Shared Regulatory Responsibility in the United States for Securities Firms' Activities

The diversity of large securities firms' financial activities subjects them to oversight by several federal regulators, including SEC, CFTC, and in some cases, the Federal Reserve. Securities firms also comply with the rules of any self-regulatory organization (SRO) that their subsidiaries belong to, such as stock or futures exchanges, as well as state securities and, in some cases, insurance regulators. Federal regulators of securities firms share the common purpose of ensuring fair and orderly markets and of protecting investors who use such markets.

The primary legislation for SEC's regulation of securities firms is the Securities Exchange Act of 1934, which requires that any persons who engage in the business of buying and selling securities for their own account or for customers must register with SEC as broker-dealers. Further, broker-dealers are generally subject to regulation by SEC and must become a member of an SRO and follow SRO rules. In addition, securities firms with subsidiaries that invest and manage customer funds are

regulated by SEC under the Investment Company or Investment Advisers Act of 1940.

Brokers accept funds from individual and institutional investors and transact business on the investors' behalf. Dealers do business for their own accounts. Broker-dealers do both. They also have financial relationships with creditors, such as banks, and counterparties, such as other broker-dealers and clearing corporations. Because the continued operation of these firms is important to many market participants, SEC requires broker-dealers to meet certain registration and operating requirements. For example, each registered broker-dealer must have sufficient net liquid assets to meet its obligations to customers, counterparties, and creditors.

Securities firms also engage in activities that do not fall within SEC's regulatory jurisdiction. For example, securities firms that trade futures products are regulated by CFTC. Futures are usually traded through broker-dealers or a separate subsidiary, but either would be registered with CFTC as a futures commision merchant (FCM). SEC officials told us that when a firm is registered both as a broker-dealer with SEC and an FCM with CFTC, it must comply with both SEC and CFTC regulations. Dually registered firms are required to meet whatever capital standards would cause them to retain the most capital.

Several large securities firms are also registered through their broker-dealer or another subsidiary as dealers in government securities. The government securities market is regulated by the U.S. Treasury, the Federal Reserve Bank of New York (FRBNY), and SEC. We have reported previously on the regulation of government securities dealers.[9]

On a day-to-day basis, the securities industry supervises itself through SROs. Securities firm subsidiaries belong to SROs, which include stock exchanges, futures exchanges, and recognized securities or futures associations. SROs establish rules to govern member conduct and trading, set qualifications for market participants, monitor daily trading activity, examine their members' financial health and compliance with rules, and investigate alleged violations of securities and futures laws. SROs monitor

[9]U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed (GAO/GGD-90-114, Sept. 14, 1990).

compliance with their own rules, as well as rules of the federal agencies that oversee them.[10]

In addition, securities firms frequently have to comply with state regulations that govern selling securities products and giving investment advice. Some firms also have insurance companies that are regulated in the states in which they do business.

## Objectives, Scope, and Methodology

This report reviews the structure, activities, and regulation of large U.S. securities firms. Our objectives were to understand and describe these firms' organizational structures, their financial activities in domestic and foreign markets, and the financial relationships that exist among the various parts of the firms. We examined the regulatory structure of these firms to determine whether gaps exist that might affect U.S. investors and the financial system. We also compared the regulation of these firms to the different regulatory approaches for bank holding companies and foreign firms doing securities business to determine the applicability of these approaches to U.S. securities firms.

The impetus for this review stems in part from concerns SEC expressed in its February 1988 report, The October 1987 Market Break, in which SEC analyzed the performance of broker-dealers during the crash and their financial condition after the crash.[11] Based on its analysis, SEC identified several aspects of the regulation of broker-dealer financial responsibility that warranted further review. Specifically, SEC expressed concern about the activities of unregulated entities affiliated with broker-dealers, the financial resources and risks taken by these entities, and the adverse effects that a failure of such entities could have on the broker-dealer. It reiterated this concern with respect to the foreign affiliates of U.S. securities firms, which are usually regulated in foreign markets. Some of SEC's concerns were later realized with Drexel's bankruptcy.

The information in this report is based on a review of 13 large firms that were judgmentally selected because of their size, their organizational structure, and the range of their activities. We focused on firms that have large securities businesses, but most also engaged in activities that are not

[10]For a more detailed explanation of SRO responsibilities, see Securities and Futures: How the Markets Developed and How They Are Regulated (GAO/GGD-86-26, May 15, 1986).

[11]The October 1987 Market Break, A Report by the Division of Market Regulation, U.S. Securities and Exchange Commission (Washington, D.C.: Feb. 1988).

directly related to their securities business. These firms include the 10 largest broker-dealers that operate in the United States, based on capital measurements reported by the Securities Industry Association as of January 1, 1990. All the firms we studied have complex holding company structures, and seven of them are owned by financial and commercial conglomerates or foreign companies.

We interviewed senior officials of these securities firms to gain an understanding of their organizational structure, the kinds of activities they engage in, where within the organization various activities are done, how the activities are funded, and what the financial relationships are among the organization's entities. We obtained their opinions about the Market Reform Act, as well as the adequacy of SEC's net capital rule and recent amendments to it. We also discussed the circumstances surrounding Drexel's failure.

We analyzed documents obtained from the firms, including organizational charts and annual reports, which contained more information about each firm's activities. We reviewed the consolidated financial statements contained in the annual reports to understand the size and financial structure of these firms, based on their assets, liabilities, capital, income, and expenses. We also reviewed the financial statements (FOCUS reports) that broker-dealers file to determine the size of broker-dealers relative to their holding company, and to examine the financial relationships that exist between broker-dealers and other parts of a securities firm.

We interviewed officials of SEC's Division of Market Regulation to discuss broker-dealer regulation, recent and proposed rule changes, and the Market Reform Act of 1990. We also discussed changes in the industry, how securities firms have responded, and how these changes have affected SEC's ability to monitor and enforce the financial responsibility standards of broker-dealers. Finally, we discussed other issues such as the causes and resolution of Drexel's bankruptcy, the role played by SROs and the Securities Investor Protection Corporation (SIPC) in monitoring broker-dealers and protecting investors, and the need for changes in SEC's jurisdiction over securities firms.

We discussed many of these issues with other market regulators, participants, and observers, such as SEC's New York Regional Office, NYSE, NASD, FRBNY, two major rating agencies, SIPC, the Securities Industry Association, an accounting firm, and several academics. We reviewed

publications that reported on trends in the securities industry and analyzed the changes that have occurred among large securities firms.

Because large U.S. securities firms are active participants in foreign markets, we met with market regulators, officials from U.S. and local firms, and industry analysts in Australia, France, Germany, Hong Kong, Japan, Singapore, Switzerland, and the United Kingdom (U.K.). We selected these countries because they have large markets that are open to foreign participation, and many firms in our study have subsidiaries there. We discussed recent changes in these markets, the activities of domestic and foreign financial firms (banks and securities firms), and the regulation of these firms. We explored the legal and financial relationships between U.S. securities firms and their foreign subsidiaries. We also discussed with foreign regulators the differences in regulatory framework between their countries and the United States, and discussed international initiatives concerning the regulation of financial markets and participants. In addition, we discussed these issues with the European Commission.

The information provided in this report concerning the regulation of financial derivative product markets and participants, government securities dealers, and bank holding companies, is drawn from previous GAO reports. (See Related GAO Products.) We sent a copy of the draft of this report to SEC. SEC's comments on our report are reproduced in appendix I and discussed, along with our evaluation, in chapter 5.

We did our work between March 1990 and August 1991 in accordance with generally accepted government auditing standards.

# The Complex Organization and Diverse Activities of U.S. Securities Firms May Increase Financial Risks to Broker-Dealers

U.S. securities firms have changed over time as new products and activities have emerged and securities markets have become more global in nature. Most of the top firms have adopted holding company structures in which the broker-dealer is one operating unit among several, sometimes hundreds, of domestic and international affiliated entities. Large securities firms now offer a variety of products and services not only through their broker-dealer but through other organizational entities as well. These diverse financial activities and the financial relationships among parent holding companies, broker-dealers, and other affiliated entities created by organizational changes may increase financial risks to the broker-dealers. The bankruptcy of Drexel illustrates how, as a result of these relationships, financial difficulties in one entity can adversely affect the stability of other entities or the entire firm.

## The Organizational Structure of Securities Firms Has Become Increasingly Complex

In the past decade, many large U.S. broker-dealers have expanded their range of activities and increased the number of operating entities that do these activities. Large broker-dealers also began establishing holding companies at the top of their corporate structure. Several of these holding companies, and the entities underneath them, have subsequently been acquired by larger financial and nonfinancial corporations. As a result, most large broker-dealers are part of complex organizational structures that can include several hundred operating entities. Many factors influence these organizational structures, including business, legal, tax, and regulatory considerations.

Because these organizations are structurally complex, several terms are used to define the various entities within them and their relationship to each other. Terms such as parent company, holding company, shell corporation, subsidiary, and affiliate generally refer to the following characteristics:

- Parent company: a company that operates and controls other companies through equity ownership. The parent company is at the top of the organizational structure. In this report, "parent company" generally refers to the larger financial or nonfinancial corporation that owns a securities firm.
- Holding company: a company that controls and directs other companies through equity ownership, and may or may not engage in business activities. There may be several holding companies under one parent company, or the parent company may be a holding company.

- Shell corporation: a corporation that usually does not have any operating business but holds a name and a license. Sometimes a shell corporation is established in anticipation of future business needs or to comply with more favorable state or host country requirements. It may also be established to limit financial liability.
- Subsidiary: a company whose shares are owned, in whole or in part, by another company. (The portion of ownership is generally greater than 50 percent.)
- Affiliate: two companies are affiliated when one owns less than a majority of the other or when both are subsidiaries of a third company. A subsidiary is always, by definition, an affiliate, but "subsidiary" is the preferred term when majority control exists.

## Broker-Dealers Are Part of Two Organizational Structures

The broker-dealers we studied are subsidiaries within one of two general organizational structures.[1] In the first structure, the broker-dealer is usually the largest subsidiary under the parent holding company. The Morgan Stanley Group Inc., whose registered broker-dealer is Morgan Stanley & Co. Incorporated, and The Bear Stearns Companies Inc., whose registered broker-dealer is Bear, Stearns & Co. Inc., are examples of this organizational structure. Six of the 13 broker-dealers we studied were in this category. These broker-dealers' assets ranged from about 35 to 98 percent of their holding companies' total assets.

In the second organizational structure, a broker-dealer and its holding company are owned by a larger corporation that may be engaged in financial or commercial activities. For example, American Express Company owns Shearson Lehman Hutton Inc.; General Electric Company owns Kidder, Peabody & Co. Inc.; and Sears, Roebuck and Co. owns Dean Witter Reynolds Inc. Included in this category are broker-dealers whose parent company is a foreign firm, such as the U.S. broker-dealer Nomura Securities International, Inc., which is owned by The Nomura Securities Co., Ltd., of Japan. Seven of the 13 broker-dealers we studied were in this category. Their assets ranged from about 10 to 41 percent of the parent company's consolidated assets.[2]

[1]A third type of organizational structure, comprised of broker-dealers that are owned by bank holding companies, is not included in this report. We addressed the regulation of these broker-dealers, called section 20 firms, and their holding companies in a separate report. See Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies (GAO/GGD-90-48, Mar. 14, 1990).

[2]One of the broker-dealers with a foreign parent is not included in this range because information about the parent company's consolidated assets was unavailable.

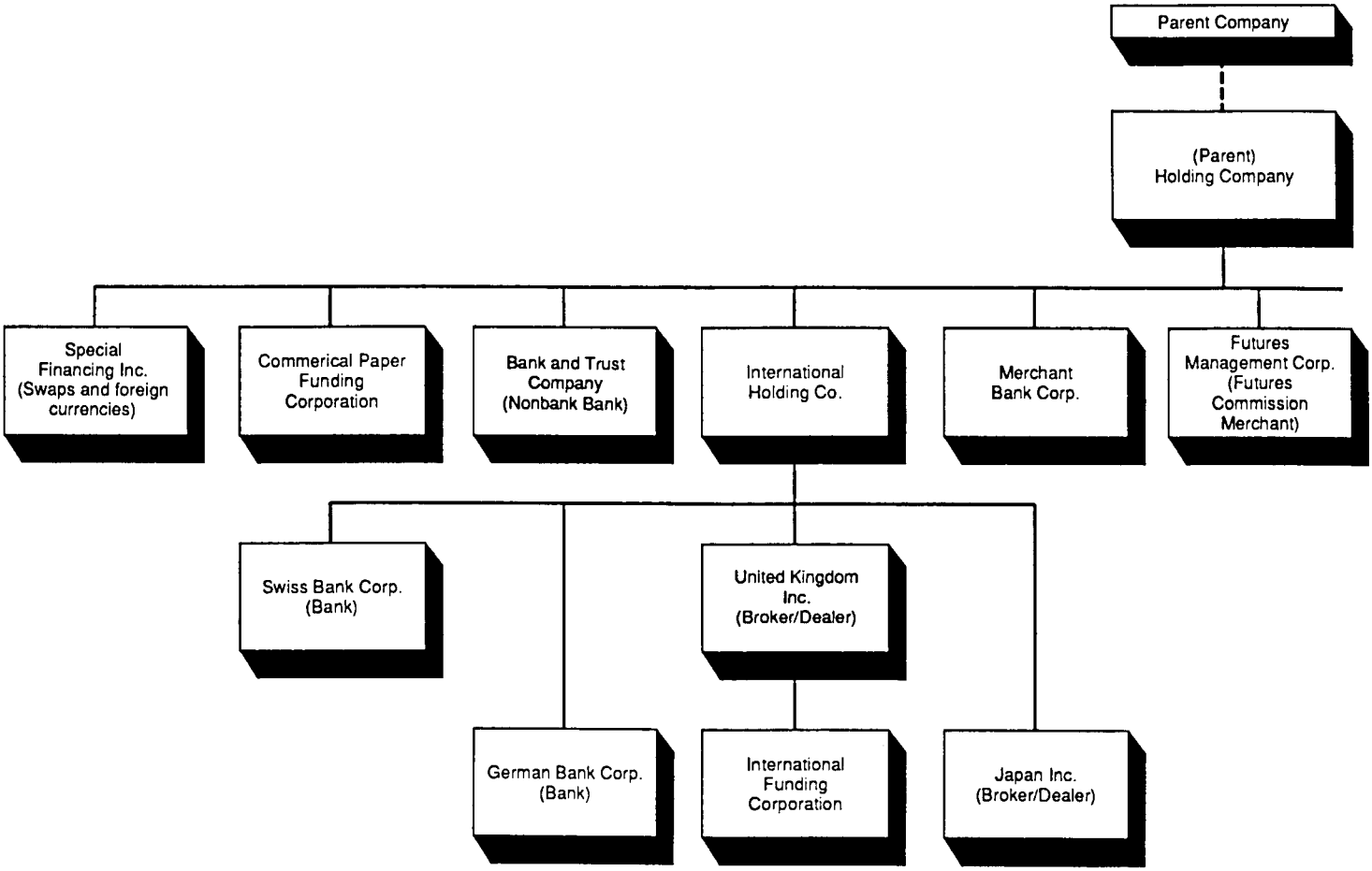
## Securities Firm Organizational Structures Can Be Complex

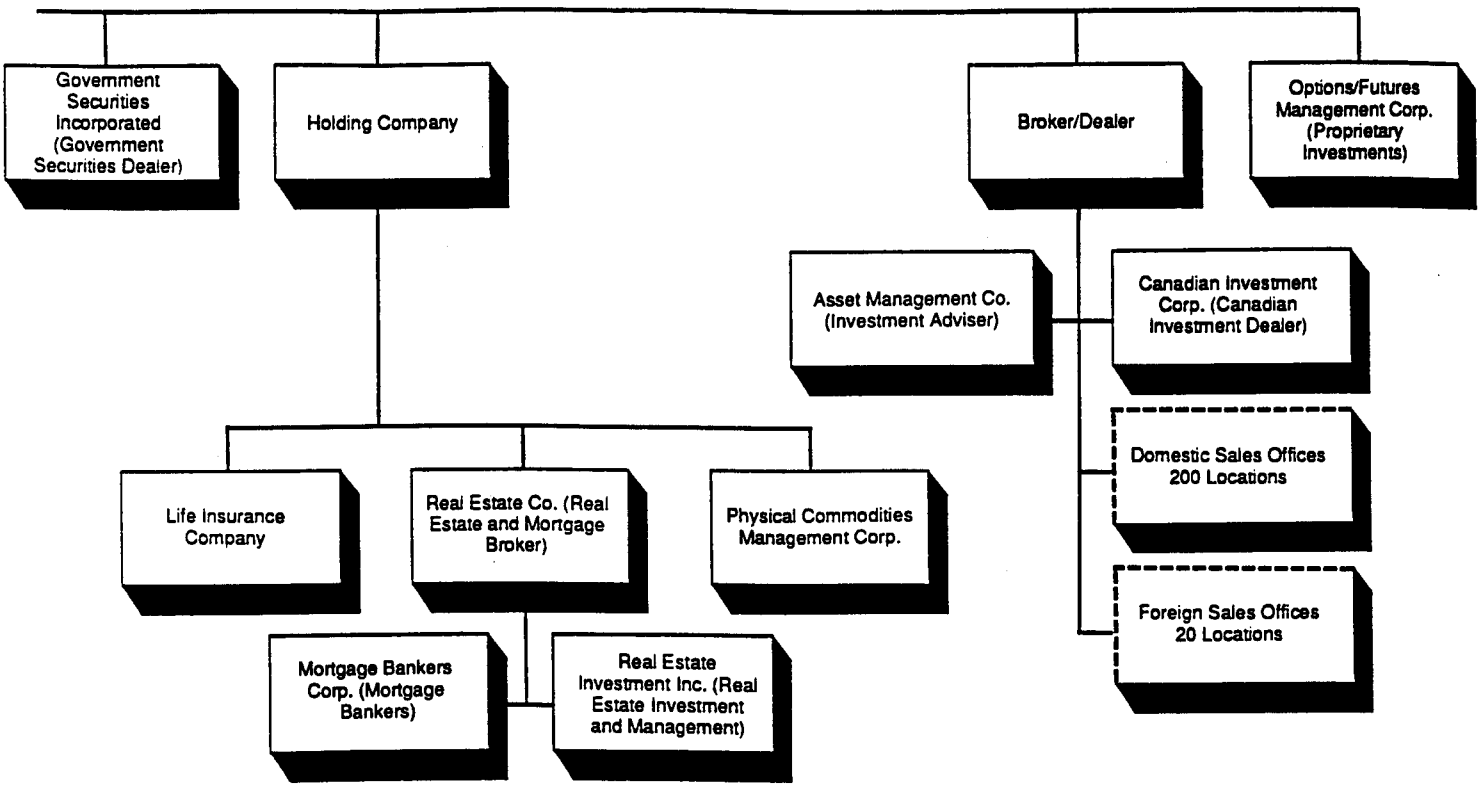
We reviewed the organization charts for 9 of the 13 firms in our sample. The others explained their organizational structure in very general terms. Most of the firms told us they could not provide detailed, up-to-date charts because the exact composition of the organization changes frequently. For example, a subsidiary might be created to handle a one-time transaction, such as a real estate investment, and then dissolved.

Even organization charts that identify only the important entities indicate that these firms have complex structures. For example, one corporation that owns a broker-dealer has over 200 separate entities on its organization chart, with 3 holding companies between the parent company and the broker-dealer. According to the chart, this firm's broker-dealer has 35 subsidiaries in the United States and 18 other countries. Officials of another broker-dealer told us that it had over 400 subsidiaries and over 300 affiliates. However, because corporate structure varies among firms, some broker-dealers we visited had less complex organizations.

Although organizational structure differs from firm to firm, we noted some common characteristics among the firms in our study. These features are depicted in figure 2.1, which shows an organizational structure chart for a hypothetical U.S. securities firm. This chart is based on the organizational structures of the firms we studied but does not represent any particular firm.

**Figure 2.1: Example of a Securities Firm's Corporate Structure**




Government Securities Incorporated (Government Securities Dealer)
Holding Company
Broker/Dealer
Options/Futures Management Corp. (Proprietary Investments)
Asset Management Co. (Investment Adviser)
Canadian Investment Corp. (Canadian Investment Dealer)
Domestic Sales Offices 200 Locations
Foreign Sales Offices 20 Locations
Life Insurance Company
Real Estate Co. (Real Estate and Mortgage Broker)
Physical Commodities Management Corp.
Mortgage Bankers Corp. (Mortgage Bankers)
Real Estate Investment Inc. (Real Estate Investment and Management)

The securities firm shown in figure 2.1 has several major subsidiaries under a holding company, including a registered broker-dealer, a government securities dealer, an FCM, a merchant banking subsidiary, a bank and trust company, two additional holding companies, and three other subsidiaries. Organized under one holding company are the securities firm's major foreign operations, such as broker-dealers in the United Kingdom and Japan, and banks in Germany and Switzerland. The U.K. broker-dealer has a subsidiary that handles funding for all international operations. Under the other holding company are a life insurance company owned by the firm, several real estate subsidiaries, and a subsidiary that manages the firm's commodities investments. Finally, this firm has a subsidiary that issues commercial paper to fund its activities, a subsidiary that engages in special financial activities, such as foreign currency trading and interest rate swaps,[3] and a subsidiary that manages the firm's own derivative product[4] investments.

The broker-dealer of this securities firm also has a number of subsidiaries. For example, it owns a Canadian investment company and has hundreds of sales office branches in the United States and smaller foreign markets. The broker-dealer also has a subsidiary that provides clearing services, and a registered investment adviser subsidiary that manages customer assets.

## Complex Organizational Structures Are a Result of Many Factors

According to broker-dealer representatives, many business, legal, tax, and regulatory considerations influence corporate structure. Several representatives told us their firms were organized along business lines and to maximize profit. Firms segregate their activities among various subsidiaries to better manage activities and to determine each activity's profitability. From a legal standpoint, a holding company structure limits financial liability within the firm. Separately incorporated entities, such as the holding company and its subsidiaries, are not legally responsible for each other's financial activities. However, because these are related companies, it is unclear whether in times of crisis the assests of one

[3]An interest rate swap is an agreement between two parties to exchange interest payments for a predetermined period of time. For example, one party may have an asset that provides a fixed rate of return for 5 years, while another party has an asset that provides a floating rate of return for 1 year. However, for 1 year, the first party would prefer to receive a floating rate of return, while the second party would prefer the stability of a fixed rate of return. Through an interest rate swap, these parties can obtain their desired payment streams without disposing of the underlying assets.

[4]A derivative product is a contract whose price is based on the value of an underlying asset such as a commodity, stock, stock index, or fixed-income security.

subsidiary may be used to support the activities of another. Tax considerations also influence corporate structure because firms that operate in several foreign markets are subject to different taxation systems and will organize their activities to minimize the firm's overall tax liability.

Regulatory requirements also influence how these firms are organized and where they transact certain activities. SEC's net capital rule (rule 15c3-1), discussed in chapter 3, influences organizationally where firms do certain financial activities because it increases the costs of doing some of these activities inside the broker-dealer. Also, according to an NYSE official, some firms do certain activities in broker-dealer affiliates rather than broker-dealer subsidiaries because of NYSE rule 322. This rule requires that registered broker-dealers be financially responsible for their subsidiaries and that each subsidiary be independently capitalized.

## Securities Firms Are Involved in Many Types of Financial Activities

The financial activities of U.S. securities firms have changed in response to developments in securities markets worldwide. Large securities firms offer many financial products and services to investors, in both domestic and foreign markets. In addition, proprietary activities, in which securities firms invest their own funds rather than customer funds, have become a more important part of their overall activities. Because these activities involve a greater level of risk than customer activities, they also account for a higher percentage of industry revenues than customer activities.

### Securities Firms Participate in U.S. Markets Through Many Subsidiaries

The broker-dealer entity, around which most of these securities firms were built, remains as their principal operating unit in the United States. Broker-dealers buy and sell securities products, such as stocks, options, bonds, and debt instruments. They may trade these products as "agents," on behalf of investors, or as "principals," for the firm's own trading and investment accounts. Broker-dealers also underwrite, or bring to the marketplace, new issues of securities products.

In addition to these activities, broker-dealers provide research and investment advice to customers, lend securities to other broker-dealers, and often maintain custody of the securities their customers purchase. Some securities firms offer investment advice and asset management services through their broker-dealer or through a separate subsidiary that is registered with SEC as an investment adviser or investment company. In exchange for such services, broker-dealers receive sales commissions and fees, which provide revenue for the firm.

Many securities firms are also active participants in futures markets. Some of the firms we studied buy and sell futures products within their broker-dealer, while others have a registered FCM that handles these activities. Like broker-dealers, FCMs also provide investment advice and custody services to their customers, and receive fees for their services. Large securities firms trade, and may underwrite, U.S. government securities, mortgage-backed government securities, and debt obligations of other federal agencies. Some of these firms have subsidiaries, called "government securities dealers," some of which are registered as primary dealers with FRBNY. Primary dealers are a group of securities dealers and commercial banks with whom FRBNY conducts its open market transactions.[5]

Other prominent lines of business for large securities firms include corporate finance, merchant banking, and related activities. These firms receive substantial fees for negotiating, advising, and financing corporate mergers, acquisitions, and leveraged buyouts. The financing for these transactions may involve underwriting corporate debt securities or providing bridge loans, as several firms did during the increased merger and acquisition activity of the mid-1980s. Bridge loan financing, in which the firm lends millions of dollars from its own funds for a short period of time, is usually done at the holding company level. Although bridge loan activity has declined recently because of defaults by certain corporations on their bridge loan obligations, some large firms still have on their books outstanding bridge loans of several hundred million dollars.

The securities firms we studied have established many other subsidiaries that engage in a variety of financial and non-financial activities. Some of these subsidiaries include insurance companies, energy-related partnerships, commodities dealers, mortgage companies, clearing corporations, and companies that specialize in real estate advice, investment, development, or management. Other subsidiaries, such as those that issue and trade commercial paper, exist primarily to raise funds

[5]FRBNY buys securities in the market when the Federal Reserve System wants to inject money into the banking system, and it sells securities when it wants to reduce the banking system's money supply. These transactions are called "open market transactions" because they are done by the open market desk of FRBNY.

for the rest of the firm. Securities firms also engage in special financial activities, such as repurchase agreements,[6] foreign currency trading, and interest rate or foreign currency swaps.

## Large U.S. Securities Firms Have Subsidiaries in Foreign Markets

The large U.S. securities firms we reviewed participated to varying degrees in foreign markets as well, providing a range of services that may include buying and selling foreign securities products on behalf of customers, providing research and investment advice, or underwriting securities products. Some U.S. firms have successfully transferred their merchant banking expertise to foreign markets, as merger and acquisition activity has increased overseas. Some firms with small operations overseas concentrate their efforts on particular activities, such as taking orders for U.S. stocks while other firms, with both large and small overseas operations, usually participate in a broad spectrum of activities. Many of these firms are members of various foreign securities, futures, and commodity exchanges.

Depending on the extent of their activities in foreign markets, large U.S. securities firms operate overseas through representative offices, branches, separately capitalized foreign subsidiaries[7] and, in some cases, banks. The firms we studied are most active in major foreign markets, such as the United Kingdom and Japan, where their subsidiaries are separately capitalized, domestic corporations.[8] The United Kingdom and Japanese subsidiaries of most large firms handle a range of financial activities comparable to what their domestic subsidiaries do in the United States. Some firms have representative offices in other European markets, such as Germany, France, and Switzerland, that provide investment advice and send customer orders to larger affiliates for processing. The firms that are more active in Germany and Switzerland have set up banks, as required by

[6]In a repurchase agreement, the firm sells a certain amount of securities and agrees to buy them back at a future time and price, plus interest.

[7]The differences between representative offices, branches, and foreign subsidiaries relate to the kind of business conducted by each. Representative offices tend to be small offices that may give investment advice and pass foreign orders for U.S. securities to the U.S. broker-dealer or a subsidiary in another country, but do not usually handle customer funds. Branches are similar to representative offices, but they may do more activities and can usually handle customer funds. Foreign subsidiaries are usually separate legal and financial entities that are incorporated outside the United States.

[8]Because Japanese securities laws prevent foreign firms from being Japanese corporations, the Japanese operations of U.S. securities firms we visited were branches of subsidiaries incorporated in the United States, the United Kingdom, and Hong Kong. However, these firms must comply with Japanese securities laws in order to do business there.

host country regulations, in order to trade and underwrite securities. Finally, a securities firm's U.S. broker-dealer may also have foreign branches or subsidiaries that receive and pass on orders for U.S. securities.

The relative importance of foreign operations to the entire securities firm, in terms of capital, assets, and revenues, varied among the firms we reviewed. Most firms estimated that their foreign operations were small relative to the U.S. broker-dealer or the parent company. However, some U.S. firms have developed sizable operations in Europe and Asia. For example, according to the 1990 annual report for one firm in our study, its European and Asian operations represented one-third of the firm's total assets and provided 40 percent of the firm's 1990 revenues.

## Increased Importance of Proprietary Transactions May Create Additional Risks for Securities Firms

Securities firms have increased their proprietary trading and investment activities since 1975, when legislative changes resulted in the elimination of fixed commission rates within the industry.[9] Negotiated rates, which were lower than the previous fixed rates, led to decreased revenues from securities firms' agency business. Forced to find new sources of revenue, securities firms began to trade financial products for their own accounts and invest their own capital to generate income. Proprietary activities include trading securities for the firm rather than for customers, engaging in arbitrage activities,[10] and providing bridge loans for mergers and acquisitions. However, these activities naturally involve more risk for the firm's capital, because proprietary activities can produce large losses as well as gains.

The sources of broker-dealer revenue, and their relative proportions, have changed significantly over the last 10 years. Negotiated commission rates and declining activity by individual investors have led to a decrease in the percent of broker-dealer revenues generated from commissions. Securities commissions represented about 34 percent of broker-dealer revenues in 1980, but this figure dropped to about 17 percent by 1990. Meanwhile, the

[9]The Securities Act Amendments of 1975 (P.L. 94-29) led to a number of changes to securities markets, including the removal of fixed brokerage commission rates. See Securities Trading: SEC Action Needed to Address National Market System Issues (GAO/GGD-90-52, Mar. 12, 1990) for a further discussion of the scope and effect of these amendments.

[10]Arbitrage is a trading strategy designed to profit from differences in price in the same, or functionally equivalent, security, currency, or commodity in two or more markets.

proportion of broker-dealer revenues derived from other sources, such as interest income[11] or fees for handling mergers, acquisitions, and private placements[12] increased from about 31 percent of industry revenues in 1980 to about 47 percent in 1990. Revenue gained from proprietary trading and investment accounts, which can fluctuate from year to year depending on market conditions, ranged from 21 to 30 percent of broker-dealer revenues between 1980 and 1990.

Although proprietary trading and investment activities have been profitable for many securities firms, they are not without risk. For example, in its October 1987 market break report, SEC stated that proprietary equity trading was the most important factor behind the losses suffered by a sample of NYSE member broker-dealers.[13] The sampled firms reported losses in October 1987 of $1.7 billion, $1.6 billion of which was attributable to proprietary trading and investment losses.

The bridge loan activity of several large securities firms provided them with tremendous fee revenues during the 1980s, but also increased their exposure to the creditworthiness of bridge loan recipients. These loans were typically short-term advances designed to be repaid with the proceeds from high yield bonds subsequently issued by the recipient. However, because of deterioration within the high yield bond market during 1989 and 1990, some securities firms made bridge loans that could not be refinanced. In addition, some corporations have defaulted on their bridge loan obligations. For example, on September 13, 1990, the Campeau Corporation defaulted on the bridge loans it had received from affiliates of three broker-dealers.[14]

[11]Repurchase and reverse repurchase agreements are the primary source of interest income.

[12]Private placements refer to new domestic issues of corporate securities not registered with SEC because they are offered to a limited group of institutional buyers.

[13]SEC selected and studied a sample of 58 NYSE member firms that dominate the securities industry and whose experiences during the October 1987 market break would approximate the experiences of the entire industry.

[14]Affiliates of The First Boston Corporation, PaineWebber Inc., and Dillon, Read & Co. Inc. jointly provided Campeau a bridge loan of about $2.1 billion to finance its 1988 takeover of Federated Department Stores Inc.

## Corporate Structure Creates Financial Relationships Within Securities Firms That Can Adversely Affect the Broker-Dealer

The corporate structure of securities firms creates financial relationships among the registered broker-dealer, the parent holding company, and other affiliated entities. As a result, the financial stability of the broker-dealer has become inextricably linked to the rest of the securities firm and can be affected by activities elsewhere in the firm. Some parent companies have responded to recent financial difficulties within their securities firm subsidiaries by providing them with additional capital or purchasing their illiquid assets. However, in Drexel's bankruptcy, the holding company had financial difficulties that adversely affected the rest of the firm, including the regulated broker-dealer.

## Funding Comes From Many Sources and Flows Throughout the Firm

Securities firms raise funds to support their activities in various ways and at various levels throughout the firm. They finance their activities with a combination of their own capital and borrowed money, or liabilities. By selling stock to public investors, firms raise equity capital. This is the purest form of capital because it is permanently available to absorb losses. Certain loans to the firm, called "subordinated liabilities," are part capital and part liability. While the firm does owe this money to a creditor, the creditor has agreed to "subordinate" its claim on the firm's assets to other creditors.[15] Subordinated liabilities meeting certain criteria, such as an agreement by the parent firm to make cash available that is adequately collateralized by proprietary securities, may be treated as capital under SEC regulation because they are available to absorb losses and protect customers.

Securities firms have many nonsubordinated liabilities as well. For example, a firm is likely to have secured and unsecured bank loans or lines of credit. Other forms of nonsubordinated liabilities include repurchase agreements, long-term debt securities, and short-term commercial paper.[16]

The use of leverage[17] has increased in the securities industry as firms rely more on liabilities than equity capital to fund their activities. A common

[15]Subordinated debt instruments require that, in the event of liquidation, repayment of principal may not be made until other debt instruments senior to it have been repaid in full.

[16]Commercial paper is a short-term unsecured promissory note that is generally sold by large corporations at a discount to institutional investors and other corporations. Commercial paper is attractive to issuers because it is unsecured, cost effective, and flexible in its terms. However, because the paper is unsecured, issuers need high credit ratings to access this market.

[17]Leverage is the ratio of a firm's debt to its equity. This ratio provides creditors with some idea of the firm's ability to withstand losses without impairing the interests of creditors. The lower this ratio is, the more buffer there is available to creditors before the firm becomes insolvent.

measurement of leverage is the ratio of total liabilities to total equity. According to SEC annual reports, this ratio increased for all registered broker-dealers from about 13 to 1 in 1980 to about 18 to 1 in 1990. In other words, for each dollar of equity held by registered broker-dealers in 1990, these firms also had 18 dollars of liabilities. The ratio of total liabilities to total equity for 9 of the 13 broker-dealers in our study, at the end of the second quarter of 1991, was greater than the 1990 industry average. The average total liabilities to total equity ratio among these 13 broker-dealers was 27 to 1.

Industry analysts and regulators have also noted a change during the last 10 years in the overall liability mix of securities firms. For example, the use of repurchase agreements and commercial paper has increased while reliance on bank loans has decreased. These sources of financing tend to be cheaper and offer the firm more flexibility than bank loans. Access to these sources depends more on the firm's credit ratings while access to bank loans depends, to a certain extent, on the firm's relationship with its banks.

The changing liability mix of securities firms is also responsive to their changing activities, which require different types of funding. Because of their involvement in a wide range of activities, as discussed earlier, firms maintain a mixture of short-term and long-term funding that carries both fixed and variable interest rates and may be denominated in foreign currencies. In this way, firms can more easily match the attributes of a financial activity with its funding source. For example, a firm that wanted to invest in Japanese equities might obtain funding for this activity denominated in yen.

Among the 13 securities firms we interviewed, responsibility for raising funds tended to be centered outside the broker-dealer. Generally, the holding company or one of its subsidiaries handles the firm's financing arrangements, such as negotiating bank lines of credit or issuing commercial paper. These funds are then loaned to subsidiaries throughout the firm, including the broker-dealer, to finance their activities. Some subsidiaries also have their own financing arrangements independent of the holding company. For example, many of the foreign subsidiaries we interviewed have established banking relationships and lines of credit in their host country. Nevertheless, a holding company's continued ability to raise funds is important to the operation of its subsidiaries.

Holding companies often loan funds to their broker-dealer to help it meet SEC's capital requirements, which are discussed in chapter 3. These loans usually appear on the broker-dealer's financial statements as subordinated liabilities. At the end of June 1991, total capital for the 13 broker-dealers in our study was nearly $26 billion, of which about $10 billion, or about 40 percent, was in the form of subordinated liabilities. These firms' financial statements do not distinguish between subordinated liabilities received from the holding company versus other sources. The proportion of subordinated liabilities in each firm's capital ranged from about 20 percent to about 67 percent.

Funds may also flow upward in the form of loan or dividend payments that broker-dealers and other subsidiaries make to their holding company. One broker-dealer official told us that loans within his organization are extended such that subsidiaries make principal and interest payments to the holding company just as they would to a bank, although the interest rates may be more favorable. Broker-dealers also pay dividends to the holding company, based on the holding company's investment in the broker-dealer. Broker-dealers and other subsidiaries could extend loans to their holding company, but the broker-dealer officials we interviewed said such loans do not usually exist in their organizations.

Funds transfers can also occur between broker-dealers and other subsidiaries of the securities firm. For example, a broker-dealer may regularly transact business with one of the firm's foreign subsidiaries. According to data provided by SEC, at the end of June 1991 investment in and receivables from other affiliates, subsidiaries, and associated partnerships for the 13 broker-dealers in our study ranged from about $9 million to about $2.5 billion. However, as discussed in chapter 3, SEC regulations decrease the incentive for a broker-dealer to loan unsecured funds to one of its affiliates.

## Several Holding Companies Have Served As a Source of Strength for Their Subsidiaries

The financial position of some securities firms has been strengthened by their affiliation with large, diversified corporations. For example, during 1990, four of these diversified corporations served as a source of strength to their securities firm's subsidiaries by providing additional capital or purchasing some of the subsidiaries' illiquid assets. However, some industry analysts have expressed concern about the extent to which such a corporation will continue to support a securities firm subsidiary in financial distress.

Several of the top U.S. securities firms, as discussed earlier, are owned by larger financial or nonfinancial corporations. These corporations are involved in various industries, such as insurance, consumer products, and real estate, and have vast financial resources. Although these corporations may lack experience in the securities industry, some market analysts state that their size and substantial capital provide added stability to their securities firm subsidiaries.

The support these corporations can provide to the industry was demonstrated during 1990, when four large securities firms that are owned by larger corporations received various forms of financial assistance from their parent companies. For example, American Express provided an additional $750 million in capital to Shearson Lehman Brothers Holdings Inc. and its broker-dealer to offset the $966 million loss incurred by these entities in 1990, following major restructuring expenses and decreased operating revenues. Following similar difficulties in 1990, the Prudential Insurance Company of America provided $200 million in capital to the holding company of its broker-dealer, now called Prudential Securities Inc., and purchased $600 million in bridge loans from an affiliate of the broker-dealer. Finally, General Electric purchased $750 million of high yield bonds and bridge loans from Kidder, Peabody & Co. Inc., and Credit Suisse contributed $300 million in capital to, and purchased a $250 million bridge loan from, The First Boston Corporation's immediate holding company. Kidder, Peabody & Co. Inc. experienced a net loss during 1990. Information about The First Boston Corporation's 1990 earnings was not publicly available.

The actions taken by these corporations substantiate expectations that they can serve as a source of strength for their securities firm subsidiaries, although they have no legal obligation to do so. Industry analysts have expressed concerns about securities firms affiliated with corporations that are not primarily engaged in financial services. For example, if a securities firm continually encountered financial problems such that it began to drain its holding company's assets, some analysts speculate that the holding company might seek to reduce its exposure and minimize further losses by allowing the securities firm to fail.[18] While such an action is certainly possible, it could be damaging to the holding company by raising further

[18]According to industry analysts, this has not happened with a large firm, but after the October 19, 1987, stock market crash, the corporate owner of H.B. Shaine allowed it to fail rather than infusing more capital.

questions about its overall financial condition and its level of commitment, where applicable, to other industries.

## Drexel's Bankruptcy Demonstrates How a Holding Company's Activities Can Harm Its Subsidiaries

Drexel's bankruptcy demonstrates how a financially weak holding company can harm the entire securities firm. Although this failure seemed sudden, a series of events and conditions created and exacerbated Drexel's financial difficulties. Of particular concern to SEC was its limited information about the financial condition and activities of the holding company and affiliates of the broker-dealer.

SEC began monitoring Drexel after the March 1989 settlement between Drexel and the United States of felony insider trading charges. This settlement required Drexel and its broker-dealer to pay fines of $650 million to the government and defrauded investors. Nonetheless, throughout 1989, Drexel's broker-dealer remained among the highest capitalized broker-dealers in the United States.

During 1989, the high yield bond market, upon which Drexel relied for a substantial portion of its revenues, became distressed as issuers began to default on their payment obligations. As a result, the issuance of new bonds and the trading of existing bonds slowed down, causing the revenues that Drexel traditionally realized from these activities to decrease.

In addition to decreased revenues, Drexel encountered severe short-term funding problems in the first 2 months of 1990. Standard & Poor's had lowered its rating of Drexel's commercial paper in December 1989, at which time Drexel had about $600 million in commercial paper outstanding. When some of this paper matured in February 1990, many investors that held the paper were unwilling to refinance and demanded payment, reducing Drexel's outstanding commercial paper to under $200 million. In addition, the holding company had a $400 million unsecured loan that matured in February 1990, and another $330 million unsecured loan that would mature in March 1990.

Financial pressure on the holding company increased when its banks were no longer willing to extend unsecured credit and would not accept Drexel's large portfolio of high yield bonds as collateral. With severely limited access to external funding sources, the holding company turned to its well-capitalized broker-dealer and government securities dealer. As discussed in chapter 3, federal regulations require these entities to hold a minimum level of capital. However, large broker-dealers and government

securities dealers often hold capital in excess of their regulatory requirements. In January 1990, Drexel withdrew about $220 million of excess capital from its broker-dealer. Although this withdrawal reduced the broker-dealer's excess capital level, it remained above the minimum required level. Nevertheless, SEC and NYSE instructed the broker-dealer not to make further loans to the holding company without prior consultation or permission from the regulators. Given the holding company's obligations, the amount withdrawn was insufficient to cover its cash flow needs, and the holding company eventually declared bankruptcy on February 13, 1990.

Following the holding company's bankruptcy, federal regulators were concerned that the broker-dealer and other subsidiaries might fail and adversely affect their customers, counterparties, creditors, and the financial system. They quickly took action to move the broker-dealer's customer accounts to other securities firms and to wind down the broker-dealer's operations. This process, which took several months to complete, was complicated by problems related to the release of collateral, the sale of assets, and the settlement of accounts. Some of the holding company's counterparties encountered delays in completing their open business with the firm, and some creditors lost money and assets they had lent to the firm. However, no broker-dealer customers lost money, and regulators prevented disruption to the financial system.

Market regulators, participants, and observers cite several factors leading to Drexel's bankruptcy that distinguish it from other large securities firms. First, the charges filed against the firm and the large fines it had to pay resulted in financial pressure and may have caused investors and other market participants to be reluctant to do business with Drexel. Second, Drexel's reliance on short-term, unsecured credit, such as commercial paper and bank loans, to fund activities that were long-term in nature caused it to be vulnerable when its access to short-term credit became limited. Finally, a substantial portion of the firm's assets were concentrated in high yield bonds. When the market for these bonds deteriorated during 1989, Drexel was exposed to both a loss of revenue and a severe decline in the value of its assets.

Several of the firms we interviewed said that a bankruptcy similar to Drexel's could conceivably happen again, but they stressed that one was unlikely for several reasons. Large securities firms tend to have a more diversified asset structure and more diversified funding sources than Drexel did. Also, some firms, particularly those that have been acquired by

large, nonfinancial corporations, may have access to additional funding from their parent in times of crisis.

## Conclusions

The increasing size and complexity of securities firms, and the financial interrelationships among their various parts, make it more difficult to determine when and if adverse conditions in one part of the firm will affect the other parts. As shown by the Drexel bankruptcy, financial relationships among Drexel's various affiliates spread the parent's financial problems throughout the rest of the firm despite the seemingly good financial condition of the affiliates. Thus, separating the financial activities of securities firms in various entities outside the broker-dealer does not necessarily protect the broker-dealer from the risks these activities pose. In the Drexel case, regulators successfully helped transfer customer accounts to other firms, and U.S. taxpayers have incurred no costs as a result of the bankruptcy.

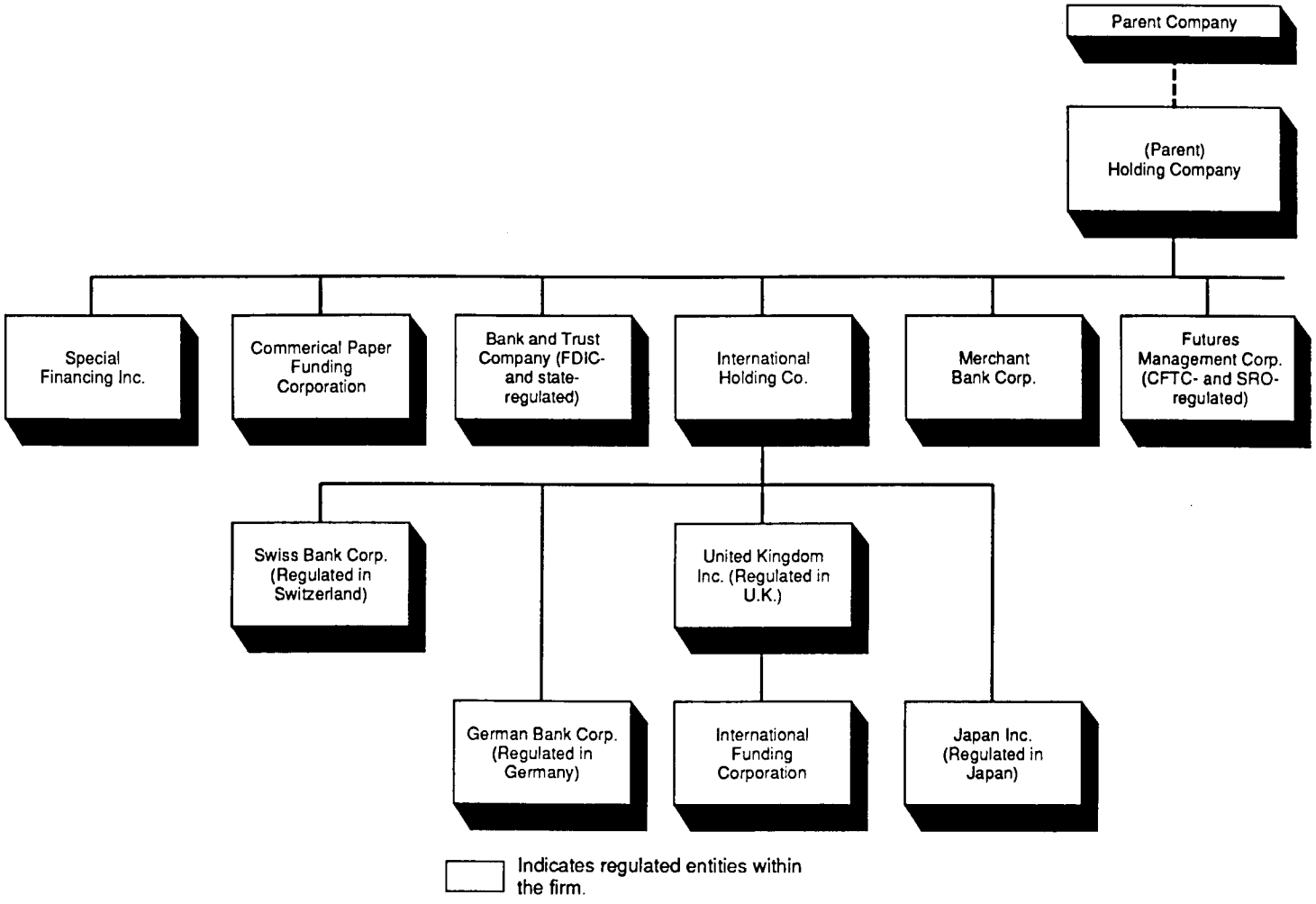
# Scope of U.S. Securities Laws Limits Regulation of Securities Firms

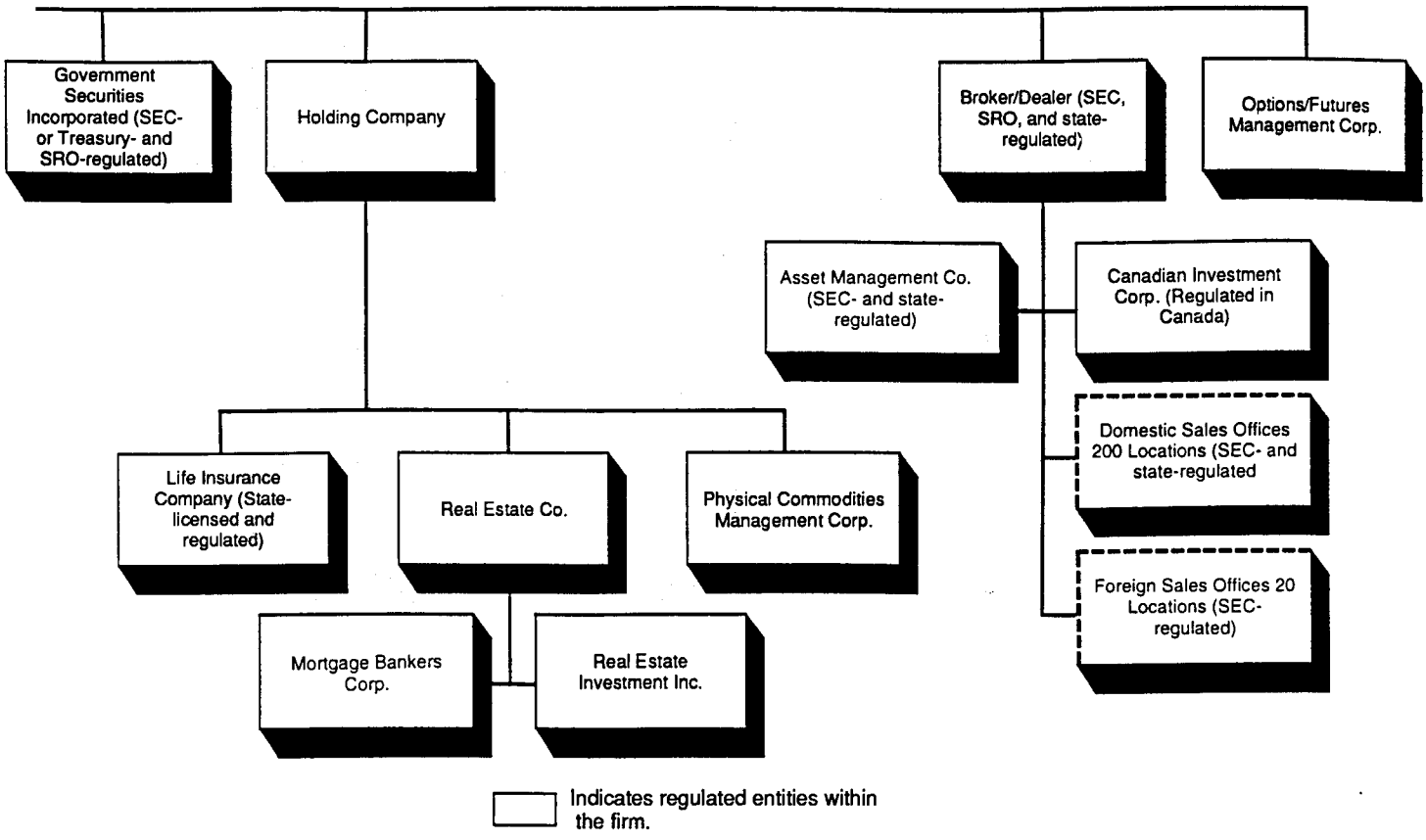
Regulation of U.S. financial markets has developed over a long period, resulting in a complicated regulatory environment characterized by a myriad of laws and regulatory agencies. SEC, CFTC, and the Federal Reserve each have jurisdiction over certain securities firm subsidiaries and their activities, as do a number of SROs and state regulators. These various regulatory programs, like SEC's regulation of broker-dealer financial responsibility, are designed to ensure the stability of the regulated entity in order to protect its customers and foster confidence in the securities industry and the financial system. However, in spite of these multiple regulators, securities firms can engage in activities that receive no regulatory coverage. Further, no federal regulator has the authority to oversee the consolidated financial condition and activities of securities firms. In response to regulators' concerns about this lack of regulatory coverage, Congress passed the Market Reform Act of 1990, which authorizes SEC to obtain information about the financial activities and condition of broker-dealer holding companies and affiliates. These expanded powers are for purposes of obtaining information only, however, and do not alter SEC's regulatory authority over securities firms.

## U.S. Securities Firm Regulation Focuses on Single Entities

The hypothetical securities firm discussed in chapter 2 would be overseen by a number of federal and state regulators, as shown in figure 3.1. These regulators focus on the safety and soundness of individual entities within the organization. We discuss SEC's regulation of broker-dealers as an example of how this regulation works. SEC's regulatory framework, like that of the other regulators of securities firm activities, has traditionally assumed that broker-dealers can be financially separated from their unregulated holding company and affiliates. As discussed in chapter 5, this approach to regulation may not adequately address the level of financial complexity these firms have attained in today's marketplace.

**Figure 3.1: Regulation of Securities Firms**




Government Securities Incorporated (SEC- or Treasury- and SRO-regulated)
Holding Company
Broker/Dealer (SEC, SRO, and state-regulated)
Options/Futures Management Corp.
Asset Management Co. (SEC- and state-regulated)
Canadian Investment Corp. (Regulated in Canada)
Domestic Sales Offices 200 Locations (SEC- and state-regulated
Foreign Sales Offices 20 Locations (SEC-regulated)
Life Insurance Company (State-licensed and regulated)
Real Estate Co.
Physical Commodities Management Corp.
Mortgage Bankers Corp.
Real Estate Investment Inc.
Indicates regulated entities within the firm.

## SEC Regulates the Activities and Financial Responsibility of Broker-Dealers

U.S. securities laws define certain financial products as "securities" that must be registered with and regulated by SEC. Generally, entities that trade these securities, both brokers and dealers, must also be registered with and regulated by SEC. SEC may be able to get firms to take action outside the specified scope of its rules and regulations.[1] However, its regulatory focus is on broker-dealers and on protecting customers from losing funds or securities held by broker-dealers, thereby fostering confidence in the securities industry and the financial system.

The term security traditionally encompasses a wide range of products including stocks, corporate and government bonds, options, and mutual funds. The actual definition of a security, as found in the Securities Act of 1933 and the Securities Exchange Act of 1934, is broad and complex.[2] Congress defined securities broadly in order to give SEC flexibility to interpret the laws as it deems appropriate to protect investors. When deciding whether a new financial product is a security, SEC considers the definition provided in the laws and the nature of the product.[3] The classification of a financial product as a security is a key factor in determining how it will be regulated.

Securities firms engage in a wide variety of financial activities, as discussed in chapter 2, that include securities and nonsecurities products. SEC

[1]For example, when SEC determined Drexel was in financial trouble, SEC requested and received financial information on the parent firm and other affiliates despite its lack of regulatory authority to do so. In addition, SEC required the broker-dealer subsidiary to stop sending funds to its parent at capital levels well above its minimum requirement. The actions SEC took relative to Drexel's bankruptcy are discussed in chapter 2.

[2]According to section 3(a)(10) of the Securities Exchange Act of 1934, the term security means any note, stock, Treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance that has a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

[3]In some cases, the determination of whether a product is a security has been made by the courts. For example, in 1989 the Federal Court of Appeals for the 7th Circuit found that index participations, which SEC had approved for trading on national securities exchanges, possess characteristics of both a security and a futures contract. Therefore, the court held that the instruments should be regulated by CFTC, which, under the Commodity Exchange Act, has exclusive jurisdiction over any futures contract (Chicago Mercantile Exchange v. Securities and Exchange Commission, et al., 883 F.2d 537 (7th Cir. 1989) cert. denied, 110 S.Ct. 3214 (1990)).

requires that activities involving securities products be transacted in registered broker-dealers, which are subject to SEC's regulation. Activities that do not involve securities products can be transacted outside the regulated broker-dealer.

Two rules form the foundation of SEC's regulation of broker-dealer financial responsibility. SEC has a customer protection rule (rule 15c3-3) that prohibits broker-dealers from using customer assets to finance their own investments, securities inventories, or operating expenses. The rule also requires broker-dealers to have physical possession or control of securities owned by their customers. These requirements protect customers in the event of a broker-dealer's liquidation by attempting to ensure that the firm has sufficient cash and securities on hand to quickly return its customers' assets to them. Additional protection for customer accounts is provided by SIPC, which operates a fund to reimburse customers if their assets are lost in a broker-dealer's failure. SIPC protects each securities customer up to $500,000 for claims for cash and securities, except that claims for cash are limited to $100,000 for each customer.

In addition to the customer protection rule, SEC's net capital rule (rule 15c3-1) requires each broker-dealer to maintain a level of capital that should allow the broker-dealer to satisfy the claims of its customers, other broker-dealers, and creditors. This capital provides a cushion of financial resources that enables broker-dealers to withstand potential losses that can result from market fluctuations or other business exposure.

While SEC's net capital rule may act to enhance the financial stability of broker-dealers, it is not designed to prevent broker-dealers from failing. However, because SEC's net capital rule requires firms to maintain sufficient liquid assets to cover all their liabilities, it also provides protection to broker-dealer counterparties and creditors.

SEC has traditionally assumed it can achieve its regulatory goal by closely examining the financial condition and activities of broker-dealers, independent of the firms with which they are associated. However, given the changes that have occurred among large securities firms, as described in chapter 2, SEC has recognized the need for additional information about activities that take place outside the regulated broker-dealer.

## The Net Capital Rule Allows SEC to Monitor the Financial Stability of Broker-Dealers

Broker-dealers must be in continual compliance with the minimum capital requirements established by rule 15c3-1, and report such compliance to SEC or their SRO on a monthly, quarterly, and annual basis. The rule also establishes an "early warning level" of capital, above a broker-dealer's minimum capital requirement, which warns SEC and SROs that a broker-dealer's capital is dropping toward its minimum requirement. SROs may also impose additional operating restrictions or warning requirements on their members, which can be more stringent than those of SEC. When a broker-dealer's net capital drops below its minimum capital requirement, SEC requires the broker-dealer to cease operations.

According to rule 15c3-1, broker-dealers are required to maintain a buffer of liquid assets in excess of their liabilities in order to cover potential market and credit risks. Broker-dealer assets include cash; money owed by customers; securities held in proprietary trading and investment accounts; and fixed assets like buildings, furniture, and equipment. Broker-dealer liabilities include money owed to customers and other broker-dealers, bank loans, debt securities issued by the broker-dealer, or funds loaned to it by the parent company.

Net capital is computed by making adjustments to a firm's net worth. Net worth is determined by subtracting total liabilities from total assets. However, some subordinated liabilities are added back to net worth because SEC allows them to count toward capital, subject to certain conditions.[4] Additional deductions are taken from net worth for illiquid assets that are not readily convertible to cash, such as unsecured loans, furniture and fixtures, and real estate. The rule further requires adjustments, called "haircuts," that anticipate possible losses in the value of certain liquid assets such as securities whose market value fluctuates. The final figure, after all adjustments are made, is referred to as net capital.

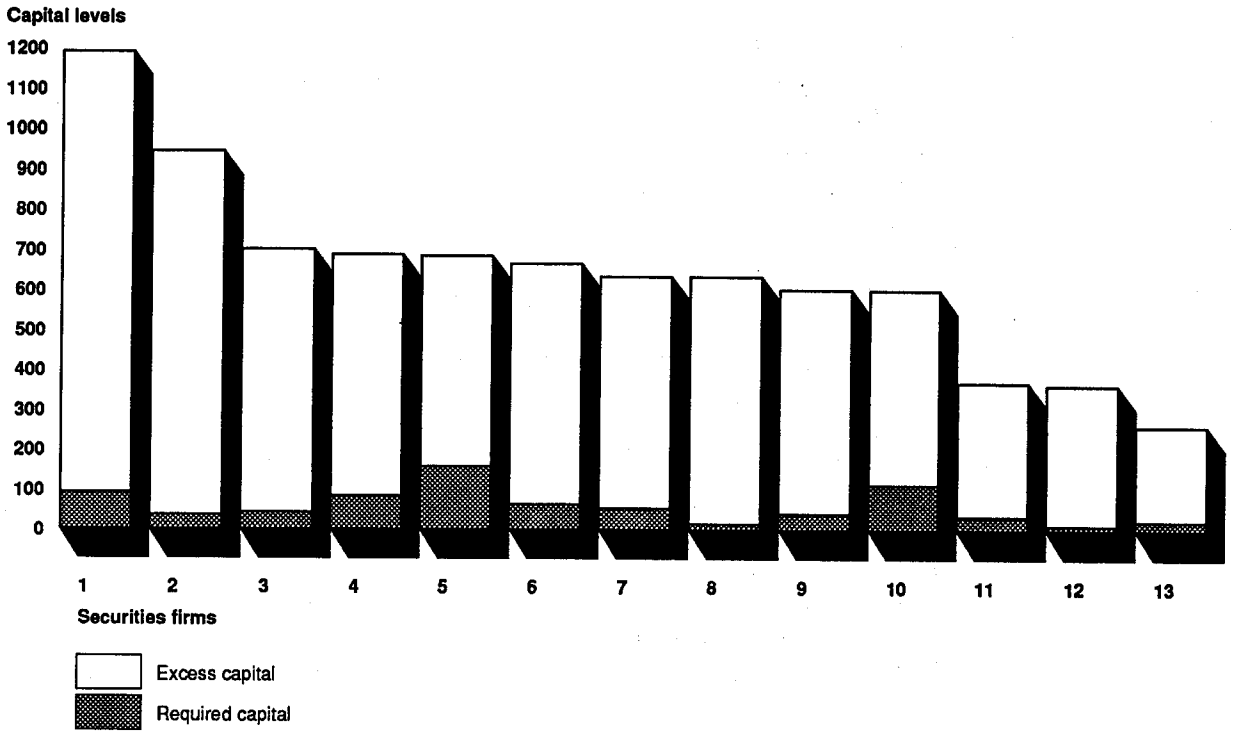
The minimum amount of capital required under the net capital rule varies from firm to firm, depending on the nature of a broker-dealer's business. Broker-dealers that maintain customer accounts generally have a higher minimum capital requirement than those that do not deal with customers. Because the net capital rule specifies a level of capital below which broker-dealers must cease operations, the net capital of most broker-dealers exceeds their minimum capital requirement. The difference

[4]In order to count toward net capital, liabilities must be subordinated to the claims of all present and future creditors, including customers; must be approved for inclusion as regulatory capital by the broker-dealer's SRO; may not be repaid if the repayment would reduce regulatory net capital below a certain level; and must have an initial term of 1 year or more.

between net capital and the minimum capital requirement is called "excess net capital."

The minimum capital requirement for the 13 broker-dealers in our study, as of June 1991, ranged from $10 million to $112 million. These firms held substantial excess net capital at that time, as shown in figure 3.2.

**Figure 3.2: Capital Levels of 13 Largest U.S. Securities Firms** (Dollars in millions)




Note: Haircuts and illiquid assets, which are not public information and which are assets of the firm, have been deducted from the required and excess capital levels shown.

Source: SEC, June 8, 1991

In addition to determining a broker-dealer's minimum capital requirement, the net capital rule specifies a level of capital above a broker-dealer's minimum requirement that is called the "early warning level." When a broker-dealer's net capital reaches or drops below its early warning level, SEC and SROs reasonably anticipate that the broker-dealer is experiencing financial difficulty that may require corrective action. Subsequent requirements imposed by the net capital rule and SROs are designed to ensure that such difficulty has a minimal effect on its customers, creditors, and counterparites. For example, the net capital rule restricts any withdrawal of capital once a broker-dealer's capital has reached its early warning level. Also, SROs may impose additional restrictions, such as requiring the broker-dealer to transfer customer accounts to another broker-dealer, liquidate securities positions, or infuse additional capital.[5]

Finally, according to SEC officials, the net capital rule adopts a conservative approach for transactions between broker-dealers and their affiliates. As discussed in chapter 2, broker-dealers may have daily business transactions with some of their affiliates and may also lend funds to, or borrow funds from, their affiliates or holding company. SEC officials said that unsecured transactions broker-dealers enter into with their affiliates or holding company are treated as "unsecured receivables" by the net capital rule. For example, if a broker-dealer provided a loan to one of its affiliates and received no collateral in exchange, the full amount of the loan would be deducted from the broker-dealer's net worth for capital purposes.

SEC officials explained that their conservative approach to broker-dealer transactions with affiliates is designed to prevent broker-dealers from giving preferential treatment to transactions with affiliates and to prevent large securities firms from using the U.S. broker-dealer's capital to fund activities elsewhere in the firm. The officials said that, while SEC does not want to overly restrict ordinary business transactions, it does closely scrutinize these activities to protect the broker-dealer's capital and, thereby, its customers.

[5]For example, NYSE rule 325 allows NYSE to impose at any time a more stringent treatment of items in computing net capital.

## Some Securities Firm Activities and Subsidiaries Remain Unregulated by U.S. Authorities

Securities firms can engage in financial activities that receive no regulatory coverage because federal and state regulators oversee only certain securities firm subsidiaries. Furthermore, the U.S. regulatory framework does not assign oversight responsibility for the entire securities firm to any single federal regulator. To a certain extent, SEC regulations influence the decision by securities firms to transact certain activities in unregulated subsidiaries. As large securities firms have expanded their range of unregulated activities, SEC's concern about the effect of these activities on the broker-dealer has increased. Under the risk assessment requirements of the Market Reform Act of 1990, SEC will begin to collect information on these activities. However, little information is available yet to measure accurately the extent of, and risks associated with, securities firms' unregulated financial activities.

## Federal Regulatory Authority Does Not Cover the Entire Securities Firm

The Securities Exchange Act of 1934, among other things, provided for the regulation of broker-dealers, through which investors participated in securities markets. In the following years, Congress passed other laws that extended SEC's authority and provided broader protection for investors.[6] While major amendments to securities legislation occurred in 1964 and 1975,[7] securities laws have never been amended to cover the entire organizational structure to which these regulated entities belong.

As discussed previously, U.S. securities firms may also be governed by the Investment Company Act and Investment Advisers Act, passed in 1940 and administered by SEC; the Commodity Exchange Act of 1936, as amended; and the Government Securities Act of 1986. The scope of these laws, like the Securities Exchange Act of 1934, is limited to certain subsidiaries and their activities.

Because federal regulators focus on individual entities within a securities firm, the information these entities provide about their financial condition and activities does not allow any federal regulator to assess the financial condition of the entire securities firm. Federal regulators have not traditionally considered such an assessment to be necessary in order to

[6]We reported on the historical development of securities and futures laws in Securities and Futures: How the Markets Developed and How They Are Regulated (GAO/GGD-86-26, May 15, 1986).

[7]The Securities Act Amendments of 1964 (P.L. 88-466) provided for, among other things, extension of disclosure and insider trading protection to the over-the-counter market, strengthening of standards and qualifications for securities firms and their employees, and tightening of the disciplinary controls of SEC and SROs. The Securities Act Amendments of 1975 were discussed briefly in chapter 2 of this report.

achieve the purpose of U.S. securities laws. However, SEC has grown concerned recently about its ability to monitor the financial condition of broker-dealers without access to information on the financial condition of their holding company and affiliates.

## SEC Regulations Influence Where Certain Activities Are Transacted

SEC does not have the authority to oversee all activities of securities firms, but its rules influence where many activities are done. SEC does not regulate transactions that do not involve securities. For example, if a broker-dealer customer transacts nonsecurity financial activities, such as buying an insurance policy, in unregulated parts of the firm, SEC would not be involved. Thus, financial activities such as bridge loans, interest rate swaps, foreign currency trading, and insurance, can be done outside the broker-dealer. SEC does not classify these activities as securities, under the statutory definition.

While SEC rules do not actually prevent the firms from doing any activities in their broker-dealer, all activities done in the broker-dealer are subject to SEC's capital requirements, thereby affecting the cost to the firm of doing certain activities in the broker-dealer. For example, SEC treats certain activities, such as bridge loans, as unsecured receivables for capital purposes. In other words, if a securities firm chose to do bridge loans in its broker-dealer, the assets created by these activities would not count toward the broker-dealer's net capital. Consequently, SEC's application of the net capital rule also influences where securities firms transact some of their activities.

Broker-dealer representatives told us that the treatment certain activities receive under SEC's net capital rule, such as bridge loans, swaps, and foreign currency trading, should be reviewed. In their opinion, the current treatment overstates the risks associated with these activities. SEC officials speculated that whether or not they reduced the haircuts on these activities, securities firms would prefer to transact the activities in unregulated subsidiaries to avoid any capital charges or regulatory scrutiny.

## Increasing Size of Unregulated Financial Activities May Affect Broker-Dealers

SEC is concerned that securities firms may manage their unregulated activities in a way that poses risk for the broker-dealer. The markets for some of these activities, such as swaps and foreign currency trading, are estimated to be large. However, because such activities have been unregulated, SEC has not been collecting specific information about

securities firms' involvement in the activities. Without this information, it is difficult to estimate the risks they present to the broker-dealer in the context of the entire firm's financial activities and condition.

In its market break report, SEC stated that unregulated subsidiaries that deal actively in foreign currencies, mortgages, and interest rate swaps are often highly leveraged and are exposed to substantial market risk and credit risk related to their transactions.[8] According to SEC, these subsidiaries and the holding company frequently have significantly less capital and financial resources than the broker-dealer. SEC is concerned about the likelihood that these entities will use the broker-dealer's excess net capital when they encounter financial difficulties.

Following a recent change to accounting standards by the Financial Accounting Standards Board (Statement of Financial Accounting Standards No. 105), securities firms are disclosing more detail in their annual reports, including information about financial instruments with off-balance-sheet risk or concentrations of credit risk. Some of these instruments are used in unregulated entities in the firms. Nevertheless, annual reports for fiscal years ending after June 15, 1990, are the first that must meet the new disclosure requirements for such activities, and the type of information reported by the firms varies. As a result, little public information is available to quantify the extent to which these firms engage in unregulated activities or the risks that such activities pose. Some information is available about the general size and volume of certain markets, such as swaps and foreign currency trading. For example, the International Swap Dealers Association, Inc., estimates the notional value of interest rate and currency swaps to have increased from about $900 billion in 1987 to about $2 trillion in 1989. A report by J.P. Morgan indicated the market had continued to grow to $2.5 trillion in 1990.[9]

[8]Market risk is the risk of loss related to changes in the value of an investment. Credit risk is the risk of loss should borrowers or counterparties default on an obligation.

[9]The notional amount of a swap is based on a hypothetical principal amount agreed to by both parties and is used to calculate the amount of interest payments that are due under a swap contract.

## New Rules and Legislation Modify SEC's Authority Over Securities Firms

In its study of the October 1987 market break, SEC expressed concern about the effect on broker-dealers of financial activities done by unregulated securities firm holding companies and other subsidiaries. Recent rule amendments and legislative changes have enhanced SEC's ability to detect problems that might arise related to these unregulated activities. For example, SEC amended its net capital rule following the Drexel bankruptcy to require that, under certain conditions, broker-dealers notify regulators when capital is transferred out of the broker-dealer. In response to SEC's concerns, Congress also recently passed the Market Reform Act of 1990, which authorizes SEC to obtain information about the unregulated financial activities and condition of broker-dealer holding companies and affiliates. These changes will provide SEC with better information concerning the financial exposure of broker-dealers. However, the basic regulatory structure governing securities firms remains the same.

### Net Capital Rule Amendments Designed to Protect Broker-Dealer Capital and Enhance SEC's Ability to Detect Problems

SEC recently amended the net capital rule to address the removal of equity capital from broker-dealers and to modify the early warning level for broker-dealers.[10] Because of the events that led to Drexel's failure, SEC amended the rule to require that broker-dealers notify SEC of certain withdrawals, and to limit the amount of equity capital that can be withdrawn from broker-dealers to benefit entities related to the broker-dealer. In changing the rule, SEC stated that it was concerned that the early warning levels established in the rule for certain broker-dealers were too low. The amendments are designed to protect a broker-dealer's capital by limiting access to it and to enhance SEC's ability to detect and respond to problems within an individual firm.

The broker-dealers that commented on the proposed rule expressed concern that the amendments, as originally proposed by SEC, were unnecessary and overly restrictive. In particular, they noted that the successful liquidation of Drexel showed that existing rules sufficiently allow SEC to monitor and react to the financial stability of broker-dealers. Some argued that the amendments were proposed in response to Drexel's unique problems, which are not prevalent throughout the industry. Finally, others suggested that the amendments restrict a holding company's ability to use its broker-dealer's excess net capital as business opportunities present themselves, and may encourage holding companies to keep less

[10]SEC Release No. 34-28927, February 28, 1991, published in the Federal Register at 56 FR 9129, Mar. 5, 1991.

excess capital in their broker-dealer. SEC's final amendments included changes to its original proposals to address these criticisms.

The net capital rule amendments require registered broker-dealers to notify SEC and their SROs 2 business days before any withdrawals of equity capital greater than 30 percent of the broker-dealer's excess net capital. Similar notification is required 2 business days after any withdrawals of equity capital that exceed 20 percent of a broker-dealer's excess net capital. Broker-dealers must consider individual withdrawals as well as the cumulative effect of all withdrawals during any 30-day period. However, withdrawals of less than $500,000 are exempt from these requirements. The amendments also authorize SEC to prohibit withdrawals of capital from broker-dealers for up to 20 business days, if the withdrawals are greater than 30 percent of a broker-dealer's excess net capital, and if SEC believes that such withdrawals would be detrimental to the financial integrity of the firm or would unduly jeopardize the broker-dealer's ability to pay its customer claims or other liabilities.

## The Market Reform Act of 1990 Provides for Risk Assessment of Securities Firm Holding Companies

SEC's ability to oversee broker-dealers' financial condition was enhanced with the passage of the Market Reform Act in October 1990 (P.L. 101-432). This act, among other things, authorized SEC to collect information from registered broker-dealers and government securities dealers about the activities and financial condition of their holding companies and unregulated affiliates. SEC's proposed rules will require firms to maintain and preserve records on financial activities that might affect the broker-dealer. SEC officials told us they plan to use this information to assess the risks presented to these regulated entities by the activities and financial condition of their affiliated organizations. Although access to this information will enhance SEC's oversight of broker-dealers and government securities dealers, the act does not change the way securities firms, as a whole, are regulated.

Section 4 of the act, entitled "Risk Assessment for Holding Company Systems," requires registered broker-dealers and municipal securities dealers that are regulated by SEC to maintain and make available to SEC certain information concerning the financial condition and activities of their holding company and affiliated entities. The act generally limits to quarterly intervals the frequency with which SEC can collect such information. However, the act also authorizes SEC to request information more frequently than quarterly if adverse market conditions or other

information cause SEC to be concerned about the financial or operational condition of a regulated entity.

On August 30, 1991, SEC proposed temporary risk assessment rules to specify what information and records broker-dealers should keep on hand and what information they will routinely report to SEC. The comment period has expired, and SEC is reviewing the more than 60 comment letters it received. In general, the proposed rules require regulated entities to provide information about their policies, procedures, or systems that monitor and control any financial or operational risks that result from the activities of their holding companies or affiliated entities. Further, these entities must describe the financial and securities activities, as well as sources of capital and funding, of affiliated entities whose business activities are reasonably likely to have a material impact on the financial or operational condition of the regulated entities. The proposed rules prescribe no specific definitions or formats for the data and allow for adjustment to the requirements as SEC and the firms gain experience with the data.

The Market Reform Act substantially expands SEC's access to information concerning the currently unregulated activities of securities firms. SEC has established a Capital Markets Group within the Division of Market Regulation to implement the act. This group plans to use information obtained under the act to examine, on a firm-by-firm basis, the financial condition and activities of broker-dealer holding companies and affiliated entities and assess any risks these unregulated entities pose to the financial stability of regulated entities. This approach is consistent with the purpose and scope of the current regulatory environment, which focuses on protecting regulated entities and their customers.

SEC officials told us their access to additional information, as provided by the Market Reform Act, will give them a better understanding of the corporate and financial structures within which broker-dealers and other regulated entities operate. This information should also give SEC and other regulators advance warning about problems faced by a broker-dealer, its holding company, or affiliated entities, that might affect the broker-dealer's financial stability. The act does not change SEC's authority to take regulatory action, which remains limited to specific subsidiaries. However, an expanded base of information may help SEC minimize the impact a broker-dealer failure has on its customers, counterparties, and the financial system.

## Conclusions

The Market Reform Act of 1990 permits SEC access to information with which it could better assess factors that might affect the financial stability of broker-dealers. This legislation may be a first step toward broadening the focus of regulation beyond the financial condition of the broker-dealer, but it provides SEC no regulatory authority to take action for activities of concern done by entities outside the broker-dealer. Whether existing regulatory authority over individual securities firm subsidiaries, bolstered by the information that SEC will collect and analyze under the Market Reform Act, is enough to provide adequate protection to investors and the financial system remains to be seen.

# U.S. Banking and Foreign Securities Regulation Involves a Comprehensive Approach

The authority granted to the Federal Reserve and many foreign financial regulators to regulate large, multiservice financial firms is fundamentally different from SEC's authority to regulate large securities firms. For example, the Bank Holding Company Act of 1956, as amended, authorizes the Federal Reserve to regulate bank holding companies on a consolidated basis. The Federal Reserve not only has authority to regulate some bank subsidiaries, but also can monitor activity and take action to stop unsafe practices anywhere in the firm. In some countries, foreign firms doing securities business are subject to regulatory structures that either provide for broader coverage of their financial activities or for consolidated regulation. However, important differences exist between the purposes of U.S. bank and securities firm regulation, and between domestic and foreign securities firm regulation, that help explain these varying regulatory approaches. Whether U.S. regulation of securities firms should be expanded is a controversial issue that requires careful analysis.

## Bank Holding Companies Are Subject to Consolidated Supervision

Bank holding companies have become the dominant form of banking organization in the United States, accounting for over 90 percent of the assets held by U.S. banks. Many similarities exist between the organizational and financial structure of bank holding companies and large securities firms. For example, a bank holding company can have many subsidiaries that engage in a variety of financial and nonfinancial activities, provided these activities are closely related to banking. A bank within such a structure is analogous to a broker-dealer within a securities firm. Both can be influenced by the financial condition of their holding company and affiliates.

The Bank Holding Company Act of 1956 and other banking laws, such as the Federal Reserve Act and the Banking Act of 1933, commonly known as the Glass-Steagall Act, limit the business activities in which banks and their affiliates may engage. The Bank Holding Company Act authorized the Federal Reserve to regulate bank holding companies and to enforce the statutes that subject bank holding companies to various controls. These controls were designed to (1) insulate banks from potential risks associated with the services and activities of their holding company parents or affiliates; (2) protect against conflict of interest abuses by, for example, providing that transactions between affiliates be made at arm's length; and (3) protect financial system stability. These controls include restricting the size and type of activities undertaken in nonbank subsidiaries, applying consolidated regulation and capital standards to the entire bank holding

company, and limiting transactions between a bank and its holding company parent or affiliates.

While the Federal Reserve is responsible for supervising holding companies, in practice it usually relies on the appropriate bank regulatory agency to supervise the bank when the bank involved is a national bank or a nonmember state bank. Similarly, under the concept of functional regulation, SEC regulates the securities subsidiaries of bank holding companies, and CFTC regulates bank holding company subsidiaries that fall under its jurisdiction.

## The Federal Reserve Can Control the Activities of Bank Holding Company Subsidiaries

The Glass-Steagall Act was enacted in 1933, after the Great Depression and thousands of bank failures in the late 1920s and early 1930s, to separate commercial banking from investment banking. This separation significantly limited the securities and other nonbanking activities of banks. However, the effectiveness of Glass-Steagall prohibitions is slowly eroding as new regulatory interpretations of long-standing statutes have allowed both banks and bank holding companies to expand into new activities.

Within the bounds provided by the banking laws, the Federal Reserve can determine bank holding company powers. The Bank Holding Company Act requires that these powers be closely related to banking and be expected to produce public benefits, such as greater convenience or increased competition, that outweigh potential adverse effects, such as unsound banking practices or conflicts of interest abuses. Within these parameters, the Federal Reserve has approved numerous activities such as providing investment advice, underwriting insurance related to the extension of credit, tax planning and preparation, data processing, and operating a credit bureau or collection agency. Subject to Glass-Steagall restrictions, bank holding companies can also do certain authorized securities activities in special subsidiaries, called "section 20" firms.[1] Securities activities approved by the Federal Reserve include underwriting and trading municipal revenue bonds, mortgage-related securities, asset-backed securities, commercial paper, and, to a limited extent, corporate debt and equity securities. To the extent these activities have been challenged in

[1]This is a reference to provisions in section 20 of the Glass-Steagall Act (12 U.S.C. 377). Section 20 prohibits banks belonging to the Federal Reserve System from affiliating with firms that are principally engaged in underwriting securities. The Federal Reserve Board interprets section 20 to allow a bank affiliate to engage in securities underwriting as long as it is not the affiliate's principal activity.

court, the judicial system consistently has upheld the Federal Reserve's action.

Besides approving new powers for bank holding companies, the Federal Reserve has imposed numerous controls to safeguard the safety and soundness of the banks affiliated with holding companies undertaking these activities. In general, bank holding companies must obtain authorization from the Federal Reserve on a case-by-case basis to enter new activities. Furthermore, if the Federal Reserve believes that any holding company activity is conducted in an unsafe and unsound manner, it can order that such activities stop. In addition, in order to control the transmission of risk to banks from nonbank activities within section 20 firms, the Federal Reserve has limited the amount of revenue a section 20 firm can earn from bank-ineligible activities, which also limits the holding company's risk exposure to such activities, and has imposed firewalls between the bank and its section 20 affiliates. Before approving applications for new activities within a section 20 subsidiary, the Federal Reserve requires a holding company to submit plans detailing how capital will be raised to fund the activities, or to demonstrate that it has, and will continue to have, adequate capital to support the new activities. Finally, as part of its regulation, the Federal Reserve has a stated policy that holding company parents should serve as a source of strength for their bank subsidiaries. This policy means that holding company parents should be prepared to use the resources of the holding company to make sure that the owned banks are adequately capitalized.

## Consolidated Capital Standards Apply to Bank Holding Companies

The capital standards that apply to bank holding companies are based on two major principles. The first is the source-of-strength policy as previously described. Second, the Federal Reserve assumes that a bank's financial condition cannot be separated from that of its holding company and affiliates. With these principles in mind, the Federal Reserve applies its capital standards to the bank holding company on a consolidated basis, and to certain regulated subsidiaries within the holding company on an individual basis.

In order to serve as sources of strength, bank holding companies are expected to hold adequate capital relative to the organization's

consolidated assets. Holding company capital requirements are the same as those applied to banks.[2] However, holding companies are required to deduct from their capital any capital contributions made to section 20 subsidiaries, to ensure that a bank holding company maintains a strong capital position independent of, and in support of, its subsidiaries.

The Federal Reserve also expects bank and nonbank subsidiaries of bank holding companies to meet industry capital requirements. Depending on their charter, banks are subject to the capital standards of the Federal Reserve, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation. Nonbank subsidiaries must be capitalized in accordance with industry standards and with the risk factors involved in the particular firm. For example, section 20 firms are subject to SEC's net capital rule. This requirement is designed to ensure that nonbank subsidiaries have sufficient capital to operate, independent of the bank or the holding company. Some nonbank subsidiaries may not be subject to any capital requirements.

## Bank Regulators Monitor Financial Relationships Between Banks and Their Affiliates

The Bank Holding Company Act and the Federal Reserve Act also limit transactions between banks and their affiliated entities. These limitations enhance the Federal Reserve's control and help insulate banks from the financial condition and activities of their affiliates. For example, while subsidiary banks are allowed to grant loans or extend credit to their parent or other affiliated companies, the amount and terms of such transactions are limited by the Federal Reserve Act.

The Federal Reserve Act restricts to a percentage of the bank's capital stock and surplus the aggregate amount of affiliated transactions in which a member bank may engage. Among the transactions covered by this restriction are extending credit to an affiliate, investing in securities issued by an affiliate, and purchasing assets from an affiliate. Any affiliate

[2]Risk-based capital requirements that will be phased in completely by year-end 1992 require banks to hold capital—composed of equity capital and other acceptable items—against both their assets and their off-balance-sheet items. The absolute amount of capital required varies with the risk weight assigned to different classes of assets and off-balance-sheet items. When the standards are fully implemented, banks will be required to hold tier 1 capital (principally equity) equal to or greater than 4 percent of their risk-weighted assets, and total capital (tier 1 plus tier 2 capital) equal to or greater than 8 percent of their risk-weighted assets. Tier 2 capital includes allowance for loan and lease losses, perpetual preferred stock and related surplus, hybrid capital instruments, and a limited amount of term subordinated debt and intermediate-term preferred stock and related surplus.

transactions allowed under the act must be subject to the same credit standards and terms that would apply to nonaffiliated companies.

Because of the potential risk involved in securities activities, the Bank Holding Company Act restricts transactions between banks and their affiliated section 20 firms. For example, the Federal Reserve prohibits banks from lending money to a section 20 affiliate that engages in securities underwriting activity. It also prohibits the purchase or sale of financial assets between banks and section 20 affiliates that engage in underwriting. Additional restrictions are placed on the internal operations of the holding company—such as prohibitions of shared boards of directors between banks and section 20s—to limit the extent to which the bank can incur risks in support of the section 20 firm.

## Securities Firms in Major Foreign Markets Are Regulated on a More Consolidated Basis

Regulators in many foreign markets like Japan and the United Kingdom tend to take a consolidated approach to the regulation of securities firms. This approach is achieved through a more centralized regulatory structure, as in Japan, or through coordination among functional regulators with one regulator setting the capital standards, as in the United Kingdom. Regulators told us that nearly all the activities of securities firms that operate in these markets are done in regulated entities and are subject to capital requirements. Consolidated supervision also allows these regulators to monitor the financial condition of the entire firm operating within their geographic jurisdiction.

### Japanese Regulation of Securities Firms Is Centralized and Structured

Securities laws in Japan were patterned after the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934. However, significant differences exist in the purpose, scope, and implementation of Japanese securities laws. First, regulation of banks and securities firms is coordinated under a central regulatory body—the Ministry of Finance (MOF). Second, MOF approves and applies capital standards to all the activities done by securities firms.

MOF has primary regulatory authority over all financial firms in Japan. This authority is exercised through a number of bureaus and organizations. The MOF's Securities Bureau implements securities laws, registers domestic and foreign securities firms, and monitors their activities. The Banking Bureau, which oversees banks; the International Finance Bureau, which oversees the foreign financial activities of Japanese firms; and the Bank of Japan, which is not technically a part of MOF, may also have jurisdiction over

certain activities of securities firms. As in the United States, SROs, such as the Tokyo Stock Exchange and the Japanese Securities Dealers Association,[3] are authorized by MOF to monitor their member firms on a daily basis and inspect their compliance with securities laws.

MOF uses a licensing system to authorize the various activities of securities firms. Firms are required to obtain separate licenses to act as a dealer, act as a broker or intermediary, underwrite securities, and handle retail distribution of publicly offered securities. Firms also obtain separate licenses for activities such as swaps, repurchase agreements, commercial paper, and foreign exchange transactions, which MOF treats as side businesses of securities firms. Indicative of MOF's influence in this area, an official of a U.S. securities firm told us the firm does not consider doing any important activity without first getting MOF's permission.

To secure licenses from MOF, firms must demonstrate they have sufficient financial resources to engage in the proposed business and personnel that have adequate knowledge and experience in the proposed business. If MOF determines that a firm's staff is not sufficiently knowledgeable in the proposed activity, it may require the firm to set aside additional capital before it begins the activity. MOF's authority over securities firms is evident in other areas as well, where any changes must be approved by MOF. For example, any anticipated increases or decreases in a firm's capital, including dividend payments to a parent company, are subject to MOF's approval. Further, MOF does not permit holding company structures in Japan. Large Japanese securities firms that participate in international markets use a holding company structure, but the holding companies are incorporated outside of Japan.

Under the Securities and Exchange Law, which is the primary legislation governing securities markets and participants, MOF has broad power to define securities activities. According to an MOF official, this law is amended every year to keep pace with market developments. All securities activities must be done within a licensed securities firm and are subject to capital requirements. As a result, MOF supervises activities that are unregulated in the United States. Only a few activities that are not defined as securities, such as fund management, can be done outside the licensed firm.

[3]All domestic and foreign broker-dealers are members of the Japanese Securities Dealers Association. This organization monitors the over-the-counter market and works closely with MOF to establish industry procedures and standards.

## Regulators in the United Kingdom Apply a Functional Approach to Oversight of Financial Firms

The primary legislation governing securities markets in the United Kingdom establishes a functional approach to regulating financial firms. This legislation, called the Financial Services Act of 1986 (FSA), broadly defines securities activities and delegates authority over these activities to a number of separate regulators. A firm that has separate subsidiaries conducting different activities is subject to oversight by more than one regulator. However, one of these is assigned the responsibility to coordinate the efforts of multiple regulators. Using this functional approach, U.K. regulators told us they oversee nearly all investment activities done by financial firms in the United Kingdom.

FSA substantially revised the structure and regulation of "investment business," or securities and futures markets, in the United Kingdom. Before the enactment of FSA, some aspects of these markets lacked comprehensive regulation. This act created a functional approach to regulation, such that all market participants engaged in a particular type of activity are now supervised under the same set of rules by the same regulator. FSA broadly defines investment products and businesses, allowing U.K. regulators to incorporate new products and activities under the act as markets evolve. The act also requires the authorization and regulation of any firm doing investment business in the United Kingdom.

The Department of Trade and Industry is the primary government agency responsible for regulating U.K. investment business. The Department has delegated its authority to the Securities and Investments Board (SIB), a private company financed by market participants. SIB establishes rules to govern investment business and investor protection, and oversees four SROs that each regulate different aspects of U.K. investment markets. For example, the Securities and Futures Authority is responsible for regulating securities and futures markets and participants.[4] SROs authorize firms to do investment business, set capital standards, and monitor compliance with SIB and SRO rules.[5]

Because firms may be subject to oversight by several regulators, the U.K. regulatory structure provides for the designation of a lead regulator, which is chosen based on the preponderance of a firm's activities. For a firm that has activities in more than one functional area, which are handled by a

[4]Other SROs are the Investment Management Regulatory Organization; the Financial Intermediaries, Managers and Brokers Regulatory Association; and the Life Assurance and Unit Trust Regulatory Organization.

[5]SIB can also authorize firms to do investment business.

single organizational entity, the lead regulator would set a capital standard to cover all such activities. When a firm is comprised of multiple entities, each entity is supervised on a stand-alone basis, with capital standards being set by the various responsible regulators. The overall supervision of all firms is achieved by the College of Regulators,[6] although such supervision is not equivalent to the consolidated financial supervision that is applied to U.S. bank holding companies.

U.K. regulators said their functional approach to regulation attempts to ensure that all of a firm's investment activities are supervised, regardless of where they are done. As a result, U.K. regulators are able to supervise financial activities in the United Kingdom that can be done by securities firms outside of regulation in the United States, such as swaps and bridge loans. This regulatory approach may remove some of the incentive for U.K. firms to spread financial activities among numerous organizational entities.

## Japanese and U.K. Standards Apply to Domestic and Foreign Securities Firms

Foreign affiliates of U.S. broker-dealers are generally regulated by their host country regulators. Because we have no authority to audit foreign regulators, we did not assess the quality of this regulation. Most foreign affiliates of U.S. securities firms tend to be small relative to the entire securities firm or broker-dealer reviewed. However, one firm already has a large portion of its operations overseas, and the size of foreign affiliates may grow considerably as international trading expands. Problems in these affiliates could eventually affect perceptions about the U.S. parent company's financial strength.

In Japan, foreign affiliates of U.S. securities firms are regulated under the Law on Foreign Securities Firms in much the same way that domestic firms are regulated under the Securities and Exchange Law. Foreign securities firms that operate in Japan are required to be branches of firms incorporated outside of Japan. However, they are separately capitalized and must adhere to the same registration and licensing requirements mentioned previously. Although the capital standards applied to foreign

[6]The College of Regulators is composed of all U.K. financial market regulators, including SIB, the Bank of England, and the various SROs, which meet at least once a year to discuss pertinent supervisory issues and can meet as needed to discuss and resolve crisis situations.

securities firms are slightly different, MOF still has to approve any changes to a foreign securities firm's capital structure.[7] Officials of U.S. securities firms indicated that this requirement makes it difficult to transfer capital out of their Japanese subsidiaries.

U.S. securities firms operate in the United Kingdom through a variety of organizational structures. Subsidiaries of many large U.S. firms are required to incorporate in the United Kingdom because they are subsidiaries of an unregulated U.S. or off-shore holding company. Securities firms also operate in the United Kingdom through branches of their U.S. broker-dealer. These branches are regulated by SEC and, pursuant to a Memorandum of Understanding between SEC and U.K. regulators, the U.K. regulators rely on U.S. regulators and SROs to monitor the capital adequacy of these firms under U.S. standards. Foreign securities firms that are incorporated in the United Kingdom are regulated under FSA as domestic firms. The U.K. subsidiaries of U.S. securities firms we visited are separately capitalized and tend to handle their own financing arrangements. Officials from these subsidiaries told us that, apart from daily business transactions, very few funds are transferred between the U.K. subsidiary and the U.S. holding company. As in Japan, any removal of capital from a U.K. securities firm must first be approved by U.K. regulators.

Domestic and foreign officials of U.S. securities firms said their operations in any given country are a small portion of their worldwide operations. These officials speculated that financial difficulties within a single foreign affiliate are unlikely to cause problems for a U.S. holding company or related broker-dealer. However, problems in the foreign operations of a U.S. firm like the one with one-third of its assets and 40 percent of its revenues oversees would certainly affect the U.S. parent and affiliate firms. Firm officials further speculated that while problems in a foreign affiliate might not have a direct financial impact on a firm's U.S. operations, such problems could affect the market's confidence in a firm.

[7]If a foreign securities firm has more than one branch in Japan, each branch must be separately capitalized, while Japanese firms can share capital among their branches. Also, foreign securities firms are permitted to include subordinated debt as part of their capital, while Japanese firms are not.

## Different Purposes for Regulation Cause Different Regulatory Approaches

Different purposes for the regulation of U.S. bank and securities firms help explain why banks are subject to consolidated regulation while U.S. securities firms are not. U.S. bank regulators regulate the banks to maintain the integrity of customer deposits and to ensure the stability of the banking system. On the other hand, as discussed in chapter 3, U.S. securities regulation has traditionally focused on protecting broker-dealer customers, thereby fostering confidence in the securities industry and in the U.S. financial system. It does not prevent firms from failing, but focuses on liquidating them in an orderly fashion. Most of the financial activities of foreign securities firms are regulated by either banking or securities regulators. U.S. bank holding companies and Japanese securities firms are subject to consolidated regulation. U.S. regulation of financial firms is changing, however, as the distinctions between banks and securities firms blur and as the size and scope of securities firm activities increase.

## Goals of U.S. Banking Laws Differ From U.S. Securities Laws

A stable U.S. banking system is important to depositors, market participants, regulators, and even other nations. Bank depositors and the financial system consider bank deposits to be no-risk assets. Banks use these deposits to provide an important backup source of liquidity for the U.S. economy through extending credit to individuals and businesses. However, banks also can make limited use of these deposits to support the activities of their affiliates or holding companies. Therefore, to ensure the safety and soundness of the bank by protecting deposit and lending functions, and to prevent inappropriate use of bank assets by affiliates or holding companies, federal bank regulators supervise banks, their affiliates, and holding companies on a consolidated basis.

The stability of broker-dealers is also important to their customers, market participants, and the U.S. financial system. Unlike banks, however, customers generally invest money through broker-dealers and assume the risks that the investment may not provide the expected level of return. Broker-dealers facilitate capital formation by helping to channel these investments to firms that need funds. They cannot use customer assets for their own purposes. Thus, customers' assets are not directly put at risk by decisions broker-dealers make, including any support that might be provided to their affiliates and holding companies. U.S. securities regulation protects customer assets held by broker-dealers.

U.S. banking and securities laws provide additional customer protection through different forms of insurance. While investor deposits with banks

are insured up to $100,000 by a fund backed by the full faith and credit of the federal government, investor cash and securities kept with securities firms are protected by an industry financed fund, SIPC, that is indirectly backed by the federal government through a $1 billion line of credit with the Treasury Department. The federal government, therefore, has a direct stake in the success or failure of a bank. The federal government's stake in securities firms is not as clear because SIPC funds have always been sufficient to handle securities firm failures without using the Treasury line of credit.

The differences in the roles played by banks and their affiliates and securities firms in the U.S. financial system have become less clear over time. The financial activities done and products offered by each are becoming more alike. For example, both do interest rate swaps and foreign exchange trading. Securities firms have depository-type accounts called "money market mutual funds," which, although securities, are functionally similar to bank deposits. Also, bank affiliates can do certain types of securities underwriting. Thus, the reasons for the traditional differences between bank and securities regulation have also become less clear.

The Market Reform Act of 1990 may be a step toward a more consolidated view of the activities of securities firms. For banks that own securities firms and securities firms that might own banks, we have already recommended a consolidated holding company regulatory structure headed by either the Federal Reserve or SEC depending on whether the bank or the securities firm is the largest part of an appropriate financial services holding company.[8] We made this recommendation for banking system stability and because of the federal government's direct guarantee of insured deposits. It is not as clear whether similar consolidated regulation is needed for securities firms that do not associate with banks, as we discuss in chapter 5. The determination will depend upon whether the broker-dealer can be isolated in a financial crisis from the activities of the rest of the firm, and the extent of risks to customers and the financial system posed by activities done outside the firms' regulated entities.

[8]Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

## The Financial Activities of Foreign Securities Firms Are Regulated

Regulation of securities firms in the foreign markets we visited covers more of these firms' financial activities than does U.S. regulation. For example, in Japan and the United Kingdom, this regulation is done on a more consolidated basis, although it is implemented differently in each country. Such an approach has been used in Japan not only to protect investors and the financial system, but also to prevent Japanese securities firms from failing. As discussed previously, a consolidated approach is also used in the United Kingdom even though maintaining market stability rather than keeping firms from failing is the stated purpose of U.K. regulation. Whether U.S. regulation of securities firms should use a consolidated approach is a controversial issue discussed further in chapter 5.

The Japanese Securities and Exchange Law was enacted in 1948. The law has been revised several times to adapt to changes that occurred in securities trading. Of particular importance was a change made in 1965 to facilitate the stability of securities firms' financial positions and business operations. In May and July of the same year two Japanese securities firms received emergency loans from the Bank of Japan and other measures to keep them from collapsing and to restore public confidence in the Japanese stock market. This event occurred after a credit crunch in 1961 caused businesses to liquidate their stock holdings, which, in turn, pushed prices down and resulted in a loss of confidence and withdrawal of public investors from the marketplace.

## Conclusions

The regulatory approaches applied to U.S. banks and foreign securities firms are more comprehensive than the approach applied to U.S. securities firms. The reasons that help explain these differences in approach are important but in and of themselves do not provide a sufficient basis to adopt or reject a broadening of the scope of regulation of U.S. securities firms.

Furthermore, the reasons for the different approaches themselves are becoming less compelling because of the blurring of the distinctions between banking and securities activities and the increases in the size and scope of U.S. securities firms and their business. Whether U.S. regulation needs to expand to cover the activities of securities firm holding companies and affiliates depends on the risks these activities pose to investors, the financial system, and the U.S. government.

# Opinions Vary on the Need for Regulating Securities Firm Holding Companies and Affiliates

So far, the U.S. regulatory scheme, which has focused on selected financial activities of large firms, has provided adequate protection to investors and the financial system in times of stress, such as the market crash of October 1987 and the failure of Drexel. However, the U.S. regulatory approach may be changing—the access to securities firm information requirements provided SEC by the Market Reform Act may be a first step toward potentially more comprehensive regulation of securities firms. Some market regulators and participants we talked to said that step would be enough. Others said regulation should be expanded to include holding company and affiliate financial activities.

Resolving this issue will require more information on the investor and financial system risks posed by these activities, and whether regulation of the activities can control or reduce such risks. Through its new authority under the Market Reform Act, SEC plans to begin assessing the risks that a securities firm's unregulated financial activities pose to its broker-dealer and the broker-dealer's customers. Expansion of this analysis may be useful in helping to identify the aggregate nature and size of U.S. securities firms' unregulated financial activities in order to determine the overall risks they present to investors, the financial system, and the U.S. government and to assess the need for regulating these activities.

## The U.S. Regulatory Scheme Has Provided Adequate Investor and System Protection in Times of Stress

The U.S. regulatory scheme for securities firms has adequately protected investors and the financial system in times of recent stress. For example, the amount of capital held by broker-dealers, as determined by the net capital rule, absorbed substantial losses incurred by these firms during the October 1987 market crash. Although some firms lost enough capital to be temporarily in violation of this rule, only a few actually went out of business.

Drexel's 1990 bankruptcy did not test the net capital rule as much as federal regulators' ability to work together to prevent a firm's failure from having a significant effect on the U.S. financial system. SEC stopped the flow of funds from the broker-dealer to the parent firm at capital levels far above the minimum requirements and facilitated the orderly transfer of 30,000 customer accounts, with $5 billion in customer property, to several securities firms. None of Drexel's customers lost money because of the bankruptcy. The primary problem for regulators in the Drexel case was unwinding millions of dollars of financial positions the firm had established without disrupting other firms that had done business with Drexel.

Although not without problems, regulators accomplished this task with minimal disruption to the financial system.

## Net Capital Rule Provided Adequate Protection to Broker-Dealers During 1987 Market Crash

No event in recent history has tested the net capital rule and the financial strength of broker-dealers more than the October 1987 market crash. In its market break study, SEC discussed the effect of the crash on selected broker-dealers and whether these broker-dealers had sufficient capital to absorb any losses they incurred. Although most broker-dealers that SEC studied experienced substantial losses because of the crash, only a small number actually went out of business. However, as a result of this experience, SEC suggested that the minimum capital requirements for various types of broker-dealers needed to be reviewed and proposed increased minimum capital requirements.

SEC studied the October 1987 financial statements of 15 of the largest broker-dealers, whose losses during the month of the crash ranged from zero to about $120 million.[1] Not surprisingly, most of these losses stemmed from a decrease in the value of their equity positions. However, according to SEC, the net capital of each of these firms, as well as all other sizable firms, remained above their early warning level despite their losses. SEC stated that the strong capital positions of large firms, and the ability of some firms to obtain additional capital from their parent company, enabled these firms to withstand their losses during the crash.

Only a small percentage of broker-dealers actually ceased operations after the October 1987 crash. SEC studied the effect of the crash on various types of broker-dealers and reported that, of 6,700 "upstairs firms" (broker-dealers that do not solely transact business on the floor of an exchange) about 58 (less than 1 percent) were in violation of the net capital rule for reasons related to the October market crash and ceased operating at least temporarily.[2] Nearly all of these firms were introducing firms, which means their customer orders are processed by other firms, and customer funds are promptly forwarded to these firms. Introducing firms pass the primary responsibility for customer assets and any bookkeeping duties associated with the resulting customer accounts to other firms. Of the 58 firms, 25 resumed operations within a month after

[1]Thirteen of the 15 firms studied incurred a loss during October 1987. The other two firms reported gains.

[2]A total of 9,515 broker-dealers were registered with SEC in 1987. The upstairs firms SEC studied represented about 70 percent of all broker-dealers registered with SEC during 1987.

the crash. Of the remaining firms that did not reopen, only one had to be liquidated by SIPC, and it was one of the three firms that held customer accounts.

In its report, SEC concluded that the October 1987 market crash generally demonstrated the resiliency of large broker-dealer firms. It also said that the capital required by the net capital rule and broker-dealers' substantial excess net capital provided a reasonable safety margin during this time. However, SEC determined that several aspects of the net capital rule needed to be reviewed. In particular, SEC stated the minimum net capital requirements for various types of broker-dealers needed to be reviewed.

SEC observed that the minimum capital levels required for transacting a securities business were established in the early 1970s and have never been adjusted for inflation. SEC stated its intention to review the minimum capital requirements for various types of broker-dealers, given the continuing higher volatility of equity markets and the degree of leverage broker-dealer customers could attain through certain new products.[3] While higher capital standards might cause some broker-dealers to leave the business and reduce the ability of new firms to enter, they would also ensure broker-dealers have a greater cushion to withstand potential losses, such as those experienced during the crash. As of January 1992, SEC staff was preparing to present the revised standards to the Commission.

## Federal Regulators Managed Drexel's Liquidation With Little Adverse Effects on Investors, the SIPC Fund, or the U.S. Financial System

Drexel's bankruptcy posed problems for federal regulators, as well as Drexel's creditors and counterparties. Regulators were concerned that the bankruptcy of one of the nation's largest securities firms could have serious adverse effects on U.S. financial markets and participants. Creditors and counterparties were concerned they would lose money as a result of their open transactions with the firm. While this liquidation required time-consuming negotiations on the part of regulators, the firm, and its creditors to resolve Drexel's financial positions, its bankruptcy had a limited impact on U.S. financial markets.

Regulators and SIPC officials speculated that, had Drexel's broker-dealer had more customer accounts, the liquidation would have been much more difficult. When Drexel declared bankruptcy, its broker-dealer had 30,000 customer accounts that were eventually transferred to other

[3]SEC specifically identified index options and futures as products that have increased the potential for substantial customer losses that the firm may have to absorb.

broker-dealers, resulting in no loss of customer funds or assets.[4] Because SIPC protects customer accounts, SIPC officials said the fewer customer accounts a firm has, the less concern SIPC has about its failure.

When federal regulators learned about the transfers of capital from Drexel's broker-dealer, they acted quickly to prohibit further transfers. As a result, the broker-dealer remained in compliance with its capital rules. The Chairman, SEC, testified that ensuring the solvency of this entity protected other broker-dealers and their customers from potential defaults on trades involving billions of dollars of securities.[5] Regulators also issued statements confirming the broker-dealer's solvency, as well as the solvency of a government securities subsidiary, and the actions being taken to preserve these entities in order to limit the impact their holding company's failure would have on the marketplace.

The Chairman further testified that SEC had worked closely with the Federal Reserve Board, FRBNY, Treasury, CFTC, and NYSE to ensure an orderly liquidation of Drexel and its subsidiaries. Although this bankruptcy had some effect on domestic and foreign markets, what had been a $28 billion institution was liquidated without direct cost to broker-dealer customers, the SIPC fund, or the federal government. However, some market observers speculated that this situation could have been much worse had regulators not found out about the transfer of funds before Drexel could drain all the capital from its broker-dealer. Information about the transfers came from FRBNY.

## Differences Exist on Regulating Securities Firm Holding Companies

Market regulators, participants, and observers are divided about the need to regulate securities firm holding companies in the United States. SEC officials, broker-dealer representatives, and others state that the current regulatory structure achieves its primary goals. Other market regulators and observers have expressed concern that the U.S. regulatory focus on the customers of broker-dealers rather than on the entire securities firm poses potential risks to the U.S. financial system and possibly to international financial markets. While opinions differ about the need to

[4]Over 300,000 accounts had been transferred to another broker-dealer in 1989, following the charges issued against the firm by SEC and the U.S. Attorney for the Southern District of New York.

[5]Statement of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, before the Committee on Banking, Housing and Urban Affairs, United States Senate, concerning the Bankruptcy of Drexel Burnham Lambert Group Inc. (Mar. 1990).

regulate securities firm holding companies, market regulators and participants agree that a number of problems would have to be overcome to develop more comprehensive regulation of securities firms.

## Some State the Current Regulatory Structure for Securities Firms Ensures Investor Protection

Officials from SEC's Division of Market Regulation told us their authority over broker-dealers, as provided by current rules and regulations, has been significantly enhanced by the information SEC may obtain under the Market Reform Act. Division of Market Regulation officials stated they see no need to regulate the activities of broker-dealer holding companies and affiliates. Their primary interest in these activities is to assess the risks they may present to a broker-dealer's financial stability. These officials said the purpose of such an assessment is to give SEC advance notice of financial problems outside a broker-dealer in order to take appropriate steps to protect the broker-dealer and its customers.

SEC officials told us they also may use the information they obtain under the Market Reform Act to evaluate the risks presented to the U.S. financial system from the activities of broker-dealer holding companies and affiliates. SEC officials said their interest in evaluating these risks stems from the changes that have occurred in the securities industry, as well as the October 1987 market crash and Drexel's bankruptcy.

The SEC officials told us that the ability to obtain information on the risk activities of the holding company and affiliated entities of the broker-dealer is their preferred approach to dealing with risks in a holding company structure. These officials stated that the SEC's strong regulatory scheme, along with the risk assessment, protects the registered broker-dealer, reduces systemic risk, and fosters confidence in the securities industry and financial system. They also said that consolidated supervision at the holding company level would impose unnecessary costs on the consolidated entities, could discourage investment in broker-dealers, and could involve securities regulators in the regulation of such diverse activities as manufacturing and retailing.

Officials of the broker-dealers we visited said the net capital rule adequately protects broker-dealer customers. Broker-dealer officials also said that, although this rule is not intended to protect the marketplace, it enhances confidence in the marketplace by contributing to broker-dealer stability. Some officials said, however, that confidence in the marketplace can be quickly eroded by psychological factors, regardless of rules and regulations.

Many broker-dealer officials said that the net capital rule is outdated and needs to be revised. In general, they said it should be less costly to transact certain activities within a broker-dealer, such as swaps and bridge loans. Some of these officials indicated that a revised rule might encourage securities firms to do certain activities within their regulated broker-dealer. However, as discussed previously, SEC officials speculated that these firms might not wish to subject swaps and bridge loans to regulatory oversight and scrutiny by moving those activities into the broker-dealer.

Finally, broker-dealer officials were divided on the issue of holding company regulation. Many said their firms are not opposed to providing SEC with information about activities in their holding company and other affiliates, but do not want these activities to be subject to additional scrutiny or regulation. An official from one broker-dealer said that holding companies are established to take risks broker-dealers cannot and that regulating them would create a disincentive to take such risks. He further stated that holding companies should be responsible for any losses they incur and should not place the broker-dealer or its customers in jeopardy.

SIPC officials also agree that SEC's net capital and customer protection rules work to protect investors, as long as the rules are followed properly. A broker-dealer that has complied with the provisions of these rules can be liquidated with little or no exposure to the SIPC fund. Many broker-dealer failures are referred to SIPC because fraudulent activities have eroded the firm's capital. SIPC officials said it is unlikely that fraudulent activities of the magnitude required to bring down a large broker-dealer could go on for very long without being detected by regulators or the firm's internal control procedures.

With respect to holding company structures, SIPC officials stated that it can be beneficial to keep certain activities away from broker-dealers in order to protect customers. At the same time, this ability makes it difficult for regulators to control the impact those activities have on broker-dealers. These officials said that complex organizational structures can complicate SIPC liquidations by making it difficult to locate a firm's assets. Complex organizational structures also confuse investors because investors may not understand which part of the organization they are dealing with.

## Others Perceive Lack of Holding Company Regulation to Be a Regulatory Gap

Foreign regulators, FRBNY and NYSE officials, and industry analysts were among those that expressed concern about the lack of holding company regulation for U.S. securities firms. Foreign regulators, in particular, perceived the lack of such oversight as a regulatory gap that poses risks to international financial markets. FRBNY and NYSE officials maintained that without regulatory authority over broker-dealer holding companies and affiliates, SEC cannot adequately monitor the risks posed to broker-dealers from these entities' activities. NYSE officials expressed further concern that the failure of a large broker-dealer could significantly disrupt the marketplace. Finally, industry analysts stressed that the capital of large broker-dealers does not reflect the full nature of risk faced by the entire securities firm.

The Organization for Economic Cooperation and Development (OECD) recently published a report[6] prepared by a group of experts on securities markets and approved and issued by its Committee on Financial Markets. This report addresses systemic risk in international securities markets. In 1988 the Committee formed a group of securities market experts from 21 countries, including the United States, and three other international organizations, to review structural changes in securities markets, risks inherent in those markets, and the various regulatory arrangements designed to contain such risks.

OECD's report focuses on the strength of the international financial system and is concerned, therefore, about the transmission of shocks from international securities markets or large domestic securities markets to the international financial system. Noting that large U.S. securities firms are prominent in international securities markets, the report says that their failure could have an international as well as domestic impact. It further says that

> "the absence in some countries—of which the United States has been by far the most important—of regulatory accountability for affiliates, subsidiaries and holding companies of regulated (non-bank) securities dealers potentially adds to systemic risk . . . . The enactment and implementation of [the Market Reform Act] would begin to plug the single most significant gap in current regulatory coverage of internationally important securities intermediaries."

We found that some foreign regulators share the OECD's perception of the U.S. regulatory structure. U.K. regulators said that while SEC does a good

[6]Systemic Risks in Securities Markets, Organization for Economic Cooperation and Development, (Paris: 1991).

job regulating broker-dealers, providing equal coverage of the entire securities firm is also important. These regulators said that supervising all activities of a firm is more effective than ensuring that a few entities are adequately capitalized.

FRBNY officials said that regulation of broker-dealer holding companies is necessary and important. These officials said that the Market Reform Act will help SEC assess the extent of risks posed to broker-dealers by unregulated financial activities. However, FRBNY officials said that simple access to information as provided by the act is not sufficient. In their opinion, SEC will need regulatory authority to examine the subsidiaries in which these activities are done. These officials indicated that even if broker-dealers send SEC accurate information about the activities of their affiliates, these firms are likely to have off-balance-sheet activities that may not be reflected in the documents they provide. FRBNY officials said that unless SEC can fully inspect the firms, it cannot accurately determine the risks that are associated with their various activities.

Similar observations were made by NYSE officials. These officials share SEC's concern that the unregulated activities of securities firms could be harmful to broker-dealers. However, they indicated that while the net capital rule adequately protects customers, the scope of SEC regulation may not adequately protect broker-dealers. NYSE officials were particularly concerned that the failure of a large broker-dealer could cause gridlock in the marketplace. The full extent of this problem would depend on which firm failed, on what the nature of its business was, on what its relationship with other market participants was, and on whether it cleared for other firms.

Officials from the two major rating agencies, Moody's Investors Service Inc., and Standard & Poor's Rating Group, stated their concerns about the role of broker-dealer capital within SEC's regulation. One rating agency's officials repeated NYSE's position that the net capital rule adequately protects broker-dealer customers and the SIPC fund by encouraging securities firms to move certain activities outside their broker-dealer, but noted that the scope of SEC regulation does not protect the financial system. Officials from the other rating agency explained that their firm analyzes broker-dealer capital adequacy differently from SEC. This firm contended that a broker-dealer's capital, including excess capital, may be inadequate if one considers all financial activities done by the broker-dealer and its affiliates, and the full extent of risk these activities present to the firm.

## Issues to Be Considered for Designing a New, More Comprehensive Regulatory Structure for Securities Firms

Several issues would have to be considered in order to design a more comprehensive regulatory structure for U.S. securities firms. First, the diverse activities of many large firms and their nonfinancial corporations make it difficult to determine which activities of these firms should be covered by regulation. Second, the appropriate regulator to be responsible for overseeing those activities would have to be determined. Finally, regulating all the activities of securities firms may limit their ability to take risks, develop innovative products, and compete with foreign securities firms.

SEC and Federal Reserve Board officials said the issue of expanding the scope of securities firm regulation is a policy question. This issue is complicated by the association of certain securities firms with commercial corporations. In addition, as discussed in chapter 2, some securities firms have subsidiaries that are involved in activities such as insurance and real estate. SEC officials suggested that it would be inappropriate to apply SEC regulations to certain parts of large securities firms or their parent organizations.

If securities firm regulation were to be modified to replicate the structure of bank holding company regulation, one regulator would have to be selected from the several that now regulate individual securities firm entities and given primary responsibility over the holding company. As discussed in chapter 4, because of the importance of federally insured deposits, we have already recommended a plan for regulating the activities of broker-dealer affiliates and holding companies when they are affiliated with a bank. Presently, sufficient information on risks of unregulated activities and their potential effects is lacking to determine whether a similar model is necessary or would work for securities firms that have no banking affiliate.

Finally, broker-dealer officials and a former SEC official argued against holding company regulation for securities firms because such regulation could have undesirable effects on these firms' ability to remain competitive. A former SEC official cautioned against regulating securities firms in the way banks and bank holding companies are regulated. In his opinion, bank regulation prevents diversification of risk in the banking industry, while securities firms have always had more flexibility to create new products, move in and out of various activities, and use their capital efficiently. Several broker-dealer officials had similar opinions and said that reporting requirements would place more scrutiny on the activities of the holding company, creating a disincentive to take risks. They said that

holding companies should be allowed to take risks but should be responsible for losses they incur and should not place the broker-dealer or its customers in jeopardy. The former SEC official also said there has not been a demonstrable need for further safety and soundness legislation for securities firms.

## Conclusions

Market regulators and participants have differing opinions about whether the current scope and purpose of U.S. securities firm regulation remain appropriate, given the changes that have occurred in the structure and activities of large U.S. securities firms. Of particular concern is whether the financial activities and condition of broker-dealer holding companies and affiliates pose risks to broker-dealers and their customers that are not adequately addressed by SEC's regulatory approach. In addition, foreign regulators are concerned that this limited regulatory coverage of large U.S. securities firms poses problems for international financial markets. To date, a careful analysis has not been made of the (1) nature and size of activities done outside broker-dealers; (2) risks these activities pose, not only to the broker-dealers, but also to the financial system and ultimately the U.S. government; (3) effects that additional regulation would have on the markets for these activities; and (4) effectiveness of the risk assessment program. These items are useful in considering the need for any modifications to the present regulatory structure for securities firms.

Such an analysis would be helpful because the environment within which securities firms operate is changing; there are widely divergent views within the securities community regarding the risks this change poses and the appropriate response from a regulatory perspective; and there is little empirical evidence readily available for use in determining which view has the most credence. The Market Reform Act has provided SEC with the authority to get the requisite data and, because SEC is in the planning stage regarding the provisions of the act, it can devise a data-gathering strategy to accommodate both its current regulatory goals and the broader analysis while minimizing the reporting burden placed on the industry. A key consideration in this regard will be determining the need to collect comparable data from each firm and, if agreed upon, to establish common definitions and formats. This need would not preclude SEC from gathering additional information from an individual firm, given the facts and circumstances. SEC has indicated that it may expand its study regarding its current regulatory goals to include an analysis of overall risks to the system.

## Recommendations

We recommend that the Chairman, SEC, use the Market Reform Act provisions to gather and study data both to accommodate its current regulatory approach and to determine whether the overall risks posed by the unregulated financial activities of broker-dealer holding companies and affiliates warrant additional regulation. We also recommend that SEC report its results as soon as posible and, if it determines that additional regulation is warranted, identify any needed legislative or regulatory changes.

## Agency Comments and Our Evaluation

In its comments on our report, SEC said that it is in the process of establishing risk assessment rules to obtain information regarding certain activities of broker-dealer affiliates, subsidiaries, and holding companies as authorized by the Market Reform Act of 1990. SEC believes that obtaining this information is the preferred approach to dealing with risks in a holding company structure. SEC opposes consolidated supervision and regulation at the holding company level because this procedure would impose unnecessary costs on the consolidated entities, could discourage investment in broker-dealers, and could involve securities regulators in regulating diverse activities such as manufacturing and retailing. SEC says further that after gaining experience with the information obtained under its risk assessment rules, it will determine whether any revisions or modifications to the rules are needed and whether any additional legislation is warranted in this area.

SEC's plan to gain experience with the data and then to determine whether additional rule or legislative changes are needed is consistent with the intent of our recommendation, provided that SEC addresses two continuing concerns. First, we are concerned that SEC's opposition to consolidated regulation indicates that SEC may have already determined, without first collecting and analyzing the data, that just obtaining information is the preferred approach to dealing with the potential risks posed by the unregulated financial activities of broker-dealer affiliates and holding companies.

We agree with SEC that it would be both inappropriate and impractical to have securities regulators oversee all activities of commercial holding companies like Sears or General Electric. However, as we discuss in this chapter, SEC should not rule out the possibility of isolating the financial activities of these firms and regulating just those activities. It is important to assess the risks these activities pose not only to the broker-dealer, but also to the financial system, before deciding whether additional regulation is practical or what changes to regulation might be needed.

Our second concern is that SEC provides no indication of a time frame to implement its approach. Financial activities done by securities firms outside the regulated broker-dealer are growing rapidly, and the potential risks and benefits of these activities are not well understood. Determining the risks these activities pose, and developing an appropriate regulatory response, should be done as soon as possible.

# Comments From the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

February 26, 1992

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

I am writing in response to your November 26, 1991 letter to Chairman Richard C. Breeden requesting the comments of the Securities and Exchange Commission ("Commission or "SEC") on the General Accounting Office's ("GAO") draft report entitled Securities Markets: Assessing the Need to Regulate Additional Financial Activities of U.S. Securities Firms.

The draft report recommends that the SEC "use the Market Reform Act provisions to gather and study data both to accommodate its current regulatory approach and to determine whether the overall risks posed by the unregulated financial activities of broker-dealer holding companies and affiliates warrant additional regulation." GAO also recommends that the SEC "report its results, and if it determines that additional regulation is warranted, identify any needed legislative or regulatory changes."

I welcome the opportunity to address the recommendation suggested in the draft report.

The Market Reform Act of 1990 (the "Reform Act") provided the SEC with the authority to obtain information regarding certain activities of broker-dealer affiliates, subsidiaries and holding companies (hereinafter referred to as "affiliates"). However, the provisions of the Reform Act do not provide the SEC with the authority to regulate the activities of broker-dealer affiliates. Rather, the Reform Act requires broker-dealers to maintain and preserve such risk assessment information as the SEC by rule prescribes with respect to those affiliates of the

broker-dealer whose "business activities are reasonably likely to have a material impact on the financial and operational condition" of the broker-dealer, including the broker-dealer's "net capital, its liquidity, or its ability to finance its operations". The statute provides that the records should concern the broker-dealer's policies, procedures, or systems for monitoring and controlling financial and operational risks to it resulting from the activities of its material affiliates and should describe, in the aggregate, each of the financial and securities activities conducted by, and the customary sources of capital and funding of affiliates whose business activities are reasonably likely to have a material impact on the broker-dealer. In addition, the Reform Act authorizes the SEC to require broker-dealers to file, no more frequently than quarterly, summary reports of the information and records maintained pursuant to the risk assessment rules.

The Reform Act also empowers the SEC to obtain more detailed reports (sometimes referred to as "call reports") during periods of market stress or when information contained in the quarterly reports or other information leads the SEC to conclude that supplemental information is necessary.

On August 30, 1991, the SEC, using its authority under the Reform Act, published for comment two rules which, together with a proposed form, would establish a risk assessment recordkeeping and reporting system for registered broker-dealers. One rule is a recordkeeping rule, which sets forth the records and other information broker-dealers would be required to maintain with respect to "material" affiliates. As proposed, the rules would require the broker-dealer to maintain, among other things, (1) an organization chart of the holding company structure; (2) each material affiliate's policies and procedures for credit control and collateral procedures, sources of funding and trading risk; (3) material pending legal or arbitration proceedings against each material affiliate; and (4) a broad range of financial information, such as consolidating and consolidated financial statements and information on the affiliates such as aggregate securities and commodities positions, aggregate amounts of interest rate swaps or other off balance sheet financial instruments, bridge loans and material extensions of credit. The second rule is a reporting rule, which would require broker-dealers to file on the required form a quarterly summary of the information required to be kept.

The risk assessment rules were proposed in order to enable the SEC to commence an on-going program of monitoring the risks posed to broker-dealers by other entities within the same holding company structure. The SEC intends to use the risk assessment rules as a part of its financial responsibility program, and it is anticipated that the risk assessment rules will provide the SEC with valuable information concerning the activities of broker-dealer affiliates. The comment period on the rule proposals has expired and the SEC staff is reviewing the more than 60 comment letters it received. Once the SEC staff has completed its evaluation of the issues raised in these letters, it will make its recommendations to the Commission on the rule proposals.

The SEC is concerned about the risks caused by affiliates to a registered broker-dealer. In conjunction with the proposal of the risk assessment rules noted above, the SEC has created a Capital Markets Group to analyze the information received under the risk assessment rules. Additionally, members of the Capital Markets Group have begun gathering publicly available information concerning broker-dealer affiliates and have conducted meetings with representatives of the self-regulatory organizations and various broker-dealers to assess the risks currently posed to registered firms by their affiliates.

While the draft report states that the SEC's authority under the Market Reform Act may be a step toward more consolidated regulation of U.S. securities firms, that Act did not provide the SEC with authority to regulate the activities of broker-dealer affiliates. As stated by the SEC in testimony before Congress regarding financial services modernization and the collapse of Drexel Burnham Lambert, the ability to obtain information on the risk activities of the holding company and affiliated entities of the broker-dealer is the preferred approach to dealing with the risks in a holding company structure. The SEC's strong regulatory scheme, along with risk assessment, protects the registered broker-dealer, reduces systemic risk and fosters confidence in the securities industry and financial system. Consolidated supervision and regulation at the holding company level would impose unnecessary costs on the consolidated entities, could discourage investment in broker-dealers and could involve securities regulators in the regulation of such diverse activities as manufacturing and retailing. [1]

[1] See e.g., Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs (July 19, (continued...)

As noted above, the risk assessment rules have not been adopted by the SEC. After the Commission has reviewed the staff's recommendations to it on the risk assessment rule proposals, it will decide on the form and content of the final risk assessment rules. Once this has occurred, and after we have gained experience with the information submitted to the SEC under the rules finally adopted, we will be able to evaluate the effectiveness of the risk assessment program. At this time, we will determine if any revisions or modifications are necessary with respect to the operation of the risk assessment rules. We would also determine whether or not any additional legislation in this area is warranted.

The Division appreciates the opportunity to comment on the draft report. We would be happy to meet with the GAO staff at your convenience to discuss our comments further. If you have any questions regarding this letter, please feel free to telephone me at (202) 272-3000.

Sincerely,

William H. Heyman

William H. Heyman
Director

[1](...continued)
1990); Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (July 11, 1990); Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs (March 2, 1990).

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